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FAIR AND EQUITABLE TAX POLICY FOR AMERICA'S WORKING FAMILIES

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

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FAIR AND EQUITABLE TAX POLICY FOR AMERICA'S WORKING FAMILIES

THURSDAY, SEPTEMBER 6, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 10:10 a.m., in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (Chairman of the Committee), presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
August 30, 2007
FC–14

CONTACT: (202) 225–1721

Chairman Rangel Announces Hearing on Fair and Equitable Tax Policy for America's Working Families

House Ways and Means Committee Chairman Charles B. Rangel (D–NY) today announced the Committee on Ways and Means will hold a hearing on fairness and equity in the Tax Code. The hearing will focus on a number of tax fairness issues, including the tax treatment of investment fund managers and the impact of the alternative minimum tax on working families. It will also examine the reasons why investment funds are being organized offshore. **The hearing will take place on Thursday, September 6, 2007, in 1100 Longworth House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

BACKGROUND:

In 2001, President Bush introduced an economic stimulus package that he said "erases inequities in the Tax Code or eases inequities in the Tax Code." At the time, there were divisions as to whether the tax cuts would provide the stimulus effect and relieve inequities in the Tax Code as suggested by the President. In addition to analyzing the effects of the President's tax packages, there are other aspects of our tax laws that are worthy of examination, including provisions related to investment funds such as private equity funds and hedge funds. Concerns have been raised about the manner in which investment fund managers are able to structure their compensation. Others have observed that current tax rules force investment funds to form outside the United States. It is appropriate to perform a comprehensive examination of fairness in the Federal income tax system to ensure that our tax policy is working effectively and fairly for all of America's working families.

In announcing the hearing, Chairman Rangel said, **"One of the fundamental duties of the Committee on Ways and Means is to conduct oversight of the Tax Code and ensure that our tax laws promote fairness and equity for America's working families. This hearing will examine a number of tax provisions to determine whether they are functioning fairly and equitably."**

FOCUS OF THE HEARING:

This hearing will focus on a comprehensive examination of Federal income tax fairness, with particular attention to investment fund manager compensation and the effects of the alternative minimum tax on tax rates.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage,

http://waysandmeans.house.gov, select "*110th Congress*" from the menu entitled, "*Committee Hearings*" (*http://waysandmeans.house.gov/Hearings.asp?congress=18*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record*." Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business **Thursday, September 20, 2007**. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman RANGEL. The Committee on Ways and Means will come to order. I wish you all a good morning, and what a wonderful opportunity for us to wish my very good friend, Sandy Levin, a very, very happy birthday.

As most of you know, when the new Congress came into effect, Jim McCrery and I had a lot of meetings to determine within the jurisdiction of the Committee on Ways and Means just what issues would lend themselves to bipartisan support. But we were very conscious of the fact that within our own party there was such strong policy differences that it would limit the ability for us to work together.

There was one thing that was abundantly clear in our discussions, and that is we had a responsibility, as the constitutional revenue-raising Committee, to take care of the problems that have been presented by the alternative minimum tax. How we did that,

of course, we have had and still do have a difference of opinion. However, I would want to make it public that we hope that the Republican minority would feel comfortable in having input in changes and reforms in the existing Code, notwithstanding the fact that ultimately you may not be able to support the package. So, while there are some revolutionary or different dramatic concepts as to which way the Code should be going, we do hope—and we will have caucuses on this where we can be candid and explain our positions—that you may want to do the best you can with a code that you don't like to perfect it, to make it at least more simple and more fairer to the taxpayers if ultimately you cannot support that package.

So, we have been driven by the alternative minimum tax. There's been a lot of interest in the papers, however, about the differences in which hedge funds and private equity funds operators are taxed. This has not been the goal of this Committee to target any of the tax provisions except the AMT. But it's fair to say that since the AMT is such an expensive revenue loser because the revenue we raised was never intended, that naturally we have to look at the entire Tax Code to reach the goal that we hope we can achieve, and that is to simplify the system so at the end of the day whether you vote for it or not, the taxpayer does not have to raise so many resources in order to find out what they owe the Federal Government; to make certain there's a sense of fairness so that the taxpayers would realize that just having higher income doesn't mean that you get more favorable rates, and that everyone that has to pay has some sense that it's a fair system.

Of course, our overall objective should always be how we can improve the economy of the United States of America and therefore be in the position to raise the revenue to make her as strong as we would want her to be. So, before I yield to the Ranking Member, I want to thank Ritchie Neal for his Subcommittee being out front and having hearings that provided for the groundwork for the hearings that we're having today, and again encourage Members of the Committee that if after the conclusion of these hearings they believe that there was something that had been missed, the fact that you may not be able to support the final product should not inhibit you from improving whatever product comes out of our Committee, and hopefully the House.

So, Ritchie, let me thank you for the work that you have done. Before I yield to the Ranking Member, I'd like to yield to you.

Mr. NEAL. Thank you, Mr. Chairman, and thanks to Mr. McCrery as well and to Mr. English as well. Clearly, the hearings have been done in a bipartisan manner.

Mr. Chairman, this morning I delivered to you and to Mr. McCrery a report on the two hearings held at the Subcommittee level on the important issue of alternative minimum tax. Since the AMT is going to be a major issue discussed during this first panel today, I want to give a brief overview to the full Committee on what we have learned.

The Ranking Member on our Subcommittee, Mr. English, and I, both have a long history in trying to combat the growing problem of AMT on middle-income families. I believe sincerely that we both

want to see some long-term solution enacted so that we can frankly move on to other subjects.

We had two very good hearings at the Subcommittee level, and the staffs worked together to find excellent witnesses across the board. Our first hearing took a big picture look at the issue, including testimony from a Treasury witness and the taxpayer advocate. No one was in disagreement that AMT is a real problem for this Congress and beyond.

Our second hearing focused on individuals and tax practitioners who have had real life experience with AMT. We heard from Maggie Rah, a constituent of mine from Chicopee, Massachusetts, whose family income of $75,000 will kick her, her husband and three kids into the AMT for 2007. Maggie told us that the extra 1,300 in AMT taxes means no trip to Disney World this year. We heard from Michael Day, a veteran firefighter from Baltimore County representing the rank-and-file firefighters, many of whom have or will be hit by AMT this year. He referred to the AMT as a middle-class punch, and he's right.

I have brought some slides to illustrate the problem that Maggie and Michael identified. In slide one, this will show—and it's from CRS, incidentally—it shows that the income level at which taxpayers might expect to AMT for 2007. You can see that a family of four taking the standard deduction and earning $66,000 may well pay higher taxes in 2007 because of AMT.

Now let's step back and take a look at the national level. Slide two. The next slide is from the Joint Committee on Taxation. Joint Tax briefed our Members a few months ago and prepared this data at the time. It shows that almost half of the 23 million AMT returns for 2007 will be from taxpayers earning between $100,000 and $200,000 annually. It also shows that almost half of the taxpayers in the 75,000 to 100,000 income group will be affected by AMT.

The next slide, slide three, is another way to look at the macro data. It's from the Congressional Budget Office, and it's from 2005. But the spike when the patch expires is the same. Note the huge jump in liability for taxpayers in the $50,000 to $100,000 range, from almost nothing to 40 percent of that income group. Also in the $100,000 to $200,000 range, you will see a spike from about 15 percent to—listen to this—80 percent of taxpayers in that group.

These are people like Maggie Rah and Michael Day paying more in taxes than they thought and losing the tax cuts that we promised them.

Slide four, the next slide also from Joint Tax, shows exactly how much of the recent tax cuts are lost to alternative minimum tax. You'll see that almost 60 percent of the tax cuts are taken back by $80,000 in income. But that those families at $200,000 are only losing 35 percent of their cuts. The AMT has a very skewed distribution.

Slide five, the next slide, is from CRS on this same topic and highlights the takeback level in effect of AMT on a family of four at various income levels. The results are the same as Joint Taxes, but you can see going across the columns how it seems that everyone was going to get a tax cut compared with the 2001 tax level,

but many, particularly those between $80,000 and $150,000, got much less of a tax cut than was promised.

As you saw in the earlier Joint Tax slide, those making over $500,000 a year represent a tiny fraction of AMT returns and therefore lose little, if any, of the promised tax cuts.

Last, let me conclude by using a slide from the Treasury Department. You'll note that we were very careful not to use any information or data from think tanks or partisan activity. Instead, we depended upon the professionals who advise us very day in a very important manner.

This slide, slide six, shows how the AMT will soon overtake regular income tax in that it will cost more to repeal AMT in 2013 than the regular income tax. For those of us that are gardeners, you can appreciate how difficult it is to get rid of an invasive plant like kudzu or bamboo. The more you trim it, the it seems to thrive. The AMT is the kudzu of our Tax Code. I think we should stop trimming it and look for a permanent solution in a bipartisan way.

Many have quibbled over whose fault it is, but I will note for the record—and I had the staff go back and get the document—when Wilbur Mills called up the conference report on tax reform on November 22nd of 1969. The vote was 381 in favor, 2 opposed, and 50 did not vote.

This is a bipartisan problem. It demands a bipartisan solution. I thank Chairman Rangel for taking up the issue once again.

Chairman RANGEL. Thank you. Thank you. Again, I'd like to publicly thank Jim McCrery for his effort to, at least on our Committee, to have some degree of civility, even though it's abundantly clear that our political persuasions do not allow us to come together in agreement as much as we would like.

Having said that, we look forward to having as much input that you can provide as we move forward to reform the Tax Code, and we do hope if there's areas of concern that you have, that you feel comfortable not only at the hearing, but Jim and I intend to have caucuses where we can exchange with each other changes we'd like to have made. So, at this point, I yield to the Ranking Member, Jim McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman. I do want to thank you for holding this hearing today. It's going to be a hearing that undoubtedly will cover a wide variety of tax topics, and we all look forward to that. It's going to be a long day, I think. So recognizing that, I'm not going to give a formal long opening statement. I might submit something for the record with your permission, Mr. Chairman. But I do want to compliment you and your staff. Generally speaking, you all have been open to us, open to our suggestions, even though you know we can't support a final product sometimes, you have been willing to at least take our suggestions and look at them. That has not always been the case. You have surprised us a couple of times, and I'm sure that was just an oversight on your part and it won't happen again.

[Laughter.]

Mr. MCCRERY. So, thank you very much for the spirit that you continue to exhibit in running this Committee both at the Member level and the staff level. So, with that, Mr. Chairman, I look for-

ward to today's hearing and exploring a wide variety of topics with the Committee.

Chairman RANGEL. We have an extraordinary list of outstanding people that have adjusted their schedule in order to bring their ideas with us. Most of you have national reputations, and the Committee really appreciates the fact that you're testifying publicly. As our staffs have asked that hopefully we would ask you to exchange some ideas with us on certain specifics if at the end of the day something had been missed. But I want to thank you on behalf of the full Committee for your dedication to your country and to this cause.

We have Dr. Leon Burman from the Urban-Brookings Tax Policy Center; Jason Furman, Director of The Hamilton Project, Brookings Institute; Douglas Holtz-Eakin, Senior Fellow, The Peterson Institution, and of course we know him as the former Director of the Congressional Budget Office.

We'll start with Dr. Burman. Most of you know that we do have the 5-minute rule and that your entire statements without objection, as well as the statement from—the opening statement from the Minority Leader, will be placed into the record without objection. Once again, we thank you and start off with Dr. Burman.

STATEMENT OF LEONARD E. BURMAN, Ph.D., DIRECTOR, URBAN-BROOKINGS TAX POLICY CENTER

Mr. BURMAN. Thank you, Mr. Chairman, Ranking Member McCrery, Members of the Committee. Thank you for inviting me to discuss the issues of tax fairness, the 2001–2006 tax cuts, and the individual alternative minimum tax.

Economic inequality is rising dramatically. Middle-class families are working harder than ever and productivity is soaring, but almost all of the gains are going to a tiny sliver of the population at the very top of the income scale.

What explains the rising inequality? Increased globalization, information technology, the decline in labor unions and the development of a winner-take-all society where top performers receive almost all of the economic rewards are all candidate explanations. None of these factors is likely to reverse, so the trend in inequality appears inexorable.

This is a problem. First, it is demoralizing for families to work so hard and fall further and further behind. Second, even if you believe that most economic growth arises from the efforts of a few highly talented individuals who deserve their outsized pay, rising inequality spurs populist calls for measures that could be very damaging to the economy, such as trade restrictions.

By comparison, a progressive income tax is a relative efficient way to reduce the disparity of aftertax incomes. But at the same time that income inequality has been approaching levels not seen since the Great Depression, the Federal tax system has become much less progressive.

Congress has enacted more than $2 trillion in tax cuts since 2001, disproportionately concentrated on the rich. In 2006, the bottom 20 percent of income earners got an average $20 tax cut—three-tenths of a percent of their income. Most in that income group got nothing. The top 20 percent got an average tax cut of al-

most $5,800 or 5.4 percent of income. At the very top where the big winners in the economic lottery reside, the average tax cut was more than 6 percent of income.

The tax cuts had another unfortunate side effect: they threaten to throw millions of American families onto the AMT. Under current law, over 23 million taxpayers will owe AMT this year. That's more than twice the number who would have been subject to the tax if the Bush tax cuts had not been enacted. The tax now hits families with very modest incomes and no special deductions, as Mr. Neal pointed out. For example, a couple with four kids earning $75,000 would see their tax more than double in 2007 because of the AMT.

The AMT also—at least in theory—takes back a substantial portion of the Bush tax cuts. Unless Congress prevents it, the AMT will slice 20 percent off of those cuts in 2007. Because they're on the AMT, that hypothetical family of six would get no benefit from the lower tax rates or higher standard deduction enacted in 2001.

Of course, Congress doesn't want to face the wrath of 23 million angry AMT taxpayers. If past practice is a guide, you will again raise the AMT exemption for a year or two to spare most of the middle class from the tax. I share Mr. Neal's view that that would be an unfortunate response.

But this means that the 2001–2006 tax cuts were really a lot bigger than budgeted. The total bill includes the cost of the periodic, increasingly expensive patches. In 2007, the patch would reduce revenues by over $50 billion. Put differently, the AMT masked a big part of the tax cuts, and probably allowed Congress to enact cuts much larger than it would have, had all of the cost been considered.

The ironic fact is that even though the AMT appears to be a money machine, it has actually undermined fiscal discipline by hiding the full cost of large tax cuts.

The AMT has other notorious defects. It's hideously complex. It actually raises marginal tax rates on most of its victims, undermining economic efficiency. And It is unfair, hammering married couples, especially those with children, and disallowing legitimate deductions. It is the perfect storm of bad tax policy.

So, what should we do? The best approach would be to finance repeal of the AMT by broadening the tax base—for example, eliminating the deductibility of state and local taxes—rather than raising rates. Even better, AMT repeal could be part of fundamental tax reform, but there are obvious political challenges to either approach.

Fortunately intermediate options exist that would help a lot. I have suggested financing AMT repeal with a surtax that would apply only to high income taxpayers. It would be very simple for taxpayers to comprehend and comply with. The Committee on Ways and Means majority staff has reportedly considered retargeting the AMT at those with very high incomes and offsetting the revenue loss through an additional income tax.

Any repeal or reform option should be budget neutral, as the PAYGO rules require. Repealing the AMT without offsetting tax increases or spending cuts would drain Federal tax revenues just as the baby boomers start retiring, and demands on the Federal Gov-

ernment begin to swell. Outright repeal of the AMT without any other offsetting changes would reduce tax revenues by more than $800 billion through fiscal year 2017 assuming that the 2001–2006 tax cuts expire as scheduled. If the tax cuts are extended, the revenue loss nearly doubles to almost $1.6 trillion. Thank you.

[The prepared statement of Mr. Burman follows:]

Embargoed Until 10am
September 6, 2007

Statement of

Leonard E. Burman[1]
Director, Tax Policy Center
Senior Fellow, the Urban Institute
www.taxpolicycenter.org

Before the
Committee on Ways and Means

Tax Fairness, the 2001-2006 Tax Cuts, and the AMT

September 6, 2007

Chairman Rangel, Ranking Member McCrery, Members of the Committee: Thank you for inviting me to discuss the issues of tax fairness, the 2001 to 2006 tax cuts, and the individual alternative minimum tax (AMT).

In brief, my testimony makes the following points:

- Income inequality has been rising since the mid-1980s and now approaches levels not seen since the Great Depression.
- The federal tax system mitigates economic inequality—and potentially at lower economic cost than other alternatives, such as trade restrictions or labor market regulations—but the recent tax cuts have disproportionately benefited those at the top, exacerbating the trend in pre-tax income.
- The tax cuts have also vastly increased the number of people potentially subject to the AMT. Barring a change in law, more than twice as many people will owe AMT in 2007 as would have under pre-2001 law. Many of the new AMT taxpayers have modest incomes.

[1] My testimony draws heavily on joint work with my Tax Policy Center colleagues, Bill Gale, Greg Leiserson, and Jeff Rohaly. All views expressed are, of course, my own.

- While the periodic temporary increases in the AMT exemption have blunted the tax's impact on the middle class, they also lead to great uncertainty about individual income tax liability and can undermine fiscal discipline.

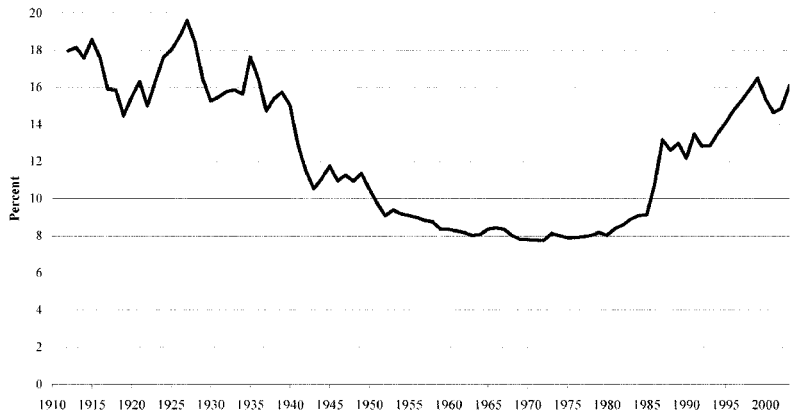
- The AMT has also masked the cost of the tax cuts. For example, in principle, the AMT will take back almost 20 percent of the income tax cuts enacted for 2007. In practice, Congress is almost sure to spare tens of millions of families from this ultra-complicated tax, so the price tag for the tax cuts is much higher than advertised.

My testimony will summarize evidence on economic inequality and the effect of the 2001–2006 tax cuts. Then I briefly describe how the AMT works and its interaction with the tax cuts. I conclude a brief discussion of how to fix the AMT in a fiscally responsible manner.

Economic Inequality and Federal Taxes

By various measures, economic inequality has been on the rise since the mid-1980s.[2] For example, economists Thomas Picketty and Emmanuel Saez (2003) have calculated that the 1 percent of households with the highest incomes now earn about 16 percent of all income (excluding volatile capital gains)—a level last seen just before the Great Depression, and twice the share seen in the 1960s and 1970s (figure 1). Data from the Congressional Budget Office (CBO) show similar trends since 1979.

Figure 1. Income Share of Top 1 Percent (excluding capital gains), 1913-2004



Source: Picketty and Saez (2003) and updated data from http://elsa.berkeley.edu/~saez/TabFig2004.xls.

[2] This is a very abbreviated summary of data I present in Burman (2007).

Explanations for rising inequality include the decline in the power of labor unions, increased immigration, and the effects of international trade and the growth in information technology (Goldin and Margo 1992). Despite remarkable gains in labor productivity, the benefits of those gains have mostly accrued to the 10 percent of Americans with the highest incomes. All other income classes have seen their wages grow more slowly than productivity. Economists Ian Dew-Becker and Robert Gordon (2005) attribute the increasing skew in earnings to "the economics of superstars," which richly rewards the top performers relative to others who are nearly as productive.

Increased inequality has *not* arisen because the middle class has become a bunch of slackers. On the contrary, sociologists Michael Hout and Caroline Hanley (2003) report that married women with children increased their average time at paid work by nearly half between 1979 and 2001, and married women without children worked over 25 percent more hours each week in 2001 than in 1979. Together, married couples increased their hours worked by more than 10 percent, whether they had children or not. The average American family is working harder than ever but, except at the top of the income scale, its income does not reflect the extra effort.

The federal tax system is one mechanism for reducing economic inequality. Although higher marginal tax rates on those with very high incomes entail an economic cost, that cost may be lower than for alternative ways of aiding working families, such as trade restrictions or regulations on firms' hiring and compensation practices. However, even while economic inequality has been approaching record levels, the tax cuts enacted since 2001 have sharply reduced progressivity.

Congress has enacted more than $2 trillion in tax cuts since 2001, disproportionately concentrated on the rich. The cuts have almost exclusively applied to the most progressive federal taxes—income and estate taxes. Only 12 percent of tax units in the bottom income quintile received any benefit, and the average tax savings for that group was about $20 in 2006 (table 1). Middle-income taxpayers received an average tax cut of $744, barely an eighth of the average $5,790 cut going to the top quintile.

Within the upper strata, the distribution of gains is even more startling. The top 1 percent—the same income group that has reaped most of the income gains in recent decades—got an average tax cut of over $44,000. The richest 0.1 percent—that is, 1 in 1,000 taxpayers—averaged over $230,000 in tax savings.

Table 1. Distribution of the 2001-2006 Tax Cuts in 2006

Cash Income Percentile	Percent of Tax Units With Tax Cut	Average Tax Change ($)	Change as Percent of After-Tax Income	Share of Total Federal Tax Change
Lowest Quintile	12.0	-20	0.3	0.3
Second Quintile	64.6	-349	2.0	4.3
Middle Quintile	87.2	-744	2.5	9.1
Fourth Quintile	97.9	-1,232	2.5	15.1
Top Quintile	99.4	-5,790	4.1	71.2
All	72.2	-1,628	3.3	100.0
Addendum				
Top 10 Percent	99.6	-8,985	4.4	55.2
Top 5 Percent	99.5	-14,039	4.6	43.1
Top 1 Percent	99.3	-44,212	5.4	27.2
Top 0.5 Percent	99.4	-74,249	5.8	22.8
Top 0.1 Percent	99.5	-230,136	6.2	14.1

Source: Tax Policy Center Table T06-0279, http://www.taxpolicycenter.org/estimates/T06-0279.

Of course, since income is highly skewed, one would expect income tax cuts to fall disproportionately on high-income taxpayers, but the recent tax cuts were much more skewed than income. For the bottom 20 percent, the tax cuts amounted to 0.3 percent of income. For the middle-income group, they were 2.5 percent, but the top 1 percent got tax cuts more than twice as large—5.4 percent of after-tax income. The top 0.1 percent saw their after-tax income increase by 6.2 percent.

How the AMT Works[3]

The individual AMT operates parallel to the regular income tax with a different income definition, rate structure, and allowable deductions, exemptions, and credits. In short, after calculating regular tax liability, taxpayers must calculate their "tentative AMT" under the alternative rules and rates and pay whichever amount is larger. To calculate tentative AMT, taxpayers must first determine their alternative minimum taxable income (AMTI) and then subtract the applicable AMT exemption amount (which phases out), calculate tax under the AMT rate schedule, and subtract any applicable credits. Technically, AMT liability is the excess, if any, of tentative AMT above the amount of taxes due under the regular income tax alone.

AMTI is the sum of three components: regular taxable income for AMT purposes, AMT preferences, and AMT adjustments. Regular taxable income for AMT purposes is basically the same as taxable income used for regular tax purposes, except it is allowed to be negative if deductions exceed gross income.

[3] For much more information and analysis related to the AMT, see the Tax Policy Center's AMT web page, available at http://www.taxpolicycenter.org/taxtopics/AMT.cfm.

An AMT preference is an item identified as a potential tax saving in the regular income tax that is not permitted in the AMT. An AMT adjustment is simply any other exclusion, exemption, deduction, credit, or other treatment (such as a method for computing depreciation) in the regular income tax that is either restricted or disallowed in the AMT. Because there is generally no important economic distinction between preferences and adjustments, I refer to both as preferences.

Interesting distinctions emerge among the preferences themselves, however. Preferences are of two types: exemptions or deferrals. Exemption preferences broaden the AMT tax base and include the disallowance of personal exemptions, the standard deduction, and itemized deductions for miscellaneous expenses and state and local taxes. Deferral provisions change the timing of the recognition of income and deductions, typically to accelerate income and postpone deductions. Thus, they tend to raise the current-year tax revenues at the expense of future tax collections.

The Joint Committee on Taxation (2007) estimates that the three largest AMT preference items in 2006 were exemption preferences that few would consider aggressive tax shelters: deductions for state and local taxes (63 percent of the dollar total); personal exemptions, including for dependent children (22 percent); and miscellaneous itemized deductions, such as for unreimbursed business expenses (11 percent). As the AMT encroaches on more middle-income taxpayers, the share of tax preferences accounted for by personal exemptions will rise to more than 40 percent as the share accounted for by the deduction for state and local taxes falls. The standard deduction will increase from 1 percent of the total in 2006 to 6 percent in 2007 as more modest-income taxpayers who do not itemize deductions become subject to the AMT.

After adding back their preference items and determining alternative minimum taxable income, taxpayers may then subtract an AMT exemption of $45,000 for couples or $33,750 for singles and heads of household in 2007. That exemption is reduced, however, for taxpayers filing joint returns with AMTI over $150,000 ($112,500 for singles and heads of household).[4] AMTI less any applicable exemption is taxed at two rates—26 percent on the first $175,000 and 28 percent on any excess above that amount. As under the regular income tax, long term capital gains and qualifying dividends face much lower tax rates: usually 15 percent. If the resulting "tentative AMT" is greater than tax before credits calculated under the regular income tax, the difference is payable as AMT. In addition, most nonrefundable tax credits (other than the foreign tax credit) are effectively disallowed by the AMT.[5]

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[4] The exemption is reduced by 25 percent of the amount that AMTI exceeds the relevant threshold. As a result, married couples filing joint returns can claim no exemption if their AMTI exceeds $330,000; single filers and heads of household get no exemption if their AMTI is greater than $247,500.

[5] To be precise, the foreign tax credit is calculated before calculating the AMT and incorporated into the comparison between regular tax liability and AMT liability. Most credits are calculated after both regular tax and AMT liability and do not affect the taxpayer's direct AMT liability. With the exception of the child tax credit and earned income tax credit, however, those credits are reduced or eliminated for taxpayers whose regular tax after credits would otherwise fall below the AMT. Effectively, the AMT disallows the

Although the two tax rates seem to make the AMT a slightly progressive tax on people with higher-than-average incomes, the phaseout of the AMT exemption at a 25 percent rate at higher incomes creates *effective* rates that are much higher in the phaseout range. Every dollar of income in the AMT phaseout range increases AMT taxable income by $1.25 (because the dollar of income reduces deductions by 25 cents). Thus, effective tax rates reach 32.5 and 35 percent in the exemption phaseout range before the advertised top rate of 28 percent kicks in at very high income levels. (The 32.5 and 35 percent rates correspond to 1.25 times 26 and 28 percent, respectively). What's more, since long-term capital gains and dividends also increase AMTI, the phaseout creates effective tax rates on capital gains and dividends of 21.5 and 22 percent, depending on the AMT tax bracket, well above the statutory maximum 15 percent rate (Leiserson 2007).

Table 2. Effective Tax Rates on Ordinary Income and Long-Term Capital Gains under the AMT, by Income, 2007

AMTI in Dollars		Tax Rate (Percent)	
Single filers	Joint filers	Ordinary income	Capital gains
33,750–112,499	45,000–149,999	26	15
112,500–189,499	150,000–205,999	32.5	21.5
190,000–247,499	206,000–329,999	35	22
247,500 and over	330,000 and over	28	15

Thus, families with moderately high incomes face much higher AMT tax rates than people with very high incomes (above the phaseout range for the AMT exemption: $247,500 for singles and $330,000 for joint returns). The much higher AMT tax rates in the phaseout range help explain why most taxpayers with incomes between $200,000 and $500,000 are on the AMT while most with incomes over $1 million are not.

Congress has limited the AMT's reach in recent years by temporarily increasing the AMT exemption and allowing the use of personal nonrefundable credits against the AMT.[6] For the 2006 tax year, for example, Congress raised the exemption from $45,000 to $62,550 for couples and from $33,750 to $42,500 for single filers and heads of household. Those changes kept 16.5 million taxpayers from falling into the AMT's clutches. Because those adjustments were temporary, however, Congress must pass additional legislation to prevent a sharp rise in the number of taxpayers subject to the AMT, from about 4 million in 2006 to more than 23 million in 2007.

credits. Temporary legislation that expired at the end of 2006 allowed the use of personal nonrefundable tax credits, such as education and dependent care tax credits, against the AMT.

[6] The Economic Growth and Tax Relief Reconciliation Act of 2001 allowed the use of the child tax credit and earned income tax credit against the AMT through 2010.

Effect of the 2001 to 2006 Tax Cuts

Even before the first of President Bush's tax cuts was enacted in 2001, the AMT was on course to grow dramatically because its parameters were not indexed for inflation. But the tax cuts enacted since 2001 magnified the problem—or would have, absent the periodic "patches" enacted to stem the effect of the big tax cuts. In 2007, about 23 million taxpayers will pay the AMT under current law (assuming no patch), more than double the 10 million that would have been affected had the tax cuts not been enacted.

Regular income taxes were cut dramatically without corresponding changes to the AMT. (As noted, the AMT exemption changes were only temporary.) Since AMT is the difference between tax calculated under the AMT rules and tax calculated under the regular income tax, anything that cuts the regular income tax without a corresponding cut in the AMT puts more taxpayers onto the AMT (and increases the AMT liability of those already affected by the tax). This problem could have been avoided by cutting AMT rates when regular income tax rates were reduced. For example, in 2001, cutting AMT rates by 4 percentage points to 22 and 24 percent would have cut the number of people subject to the AMT but would also have added about $300 billion to the cost of the 2001 act. Faced with a limited budget for tax cuts, lawmakers opted instead to postpone acknowledging the effect of the tax cuts on the AMT.

As a result, the costs of the AMT portion of the tax cuts have been paid on a kind of installment plan. Congress has increased or extended the AMT exemption three times since 2001. The last extension expired at the end of 2006.

Unless Congress acts, the AMT will take back almost 20 percent of the Bush tax cuts in 2007. (See table 3.) That take-back is not uniform, however. Households with low or very high incomes are relatively unaffected by the AMT, but those with incomes between $75,000 and $100,000 lose more than 11 percent of the putative tax cut, and those with incomes between $100,000 and $200,000 lose 34 percent. Most affected are households with incomes between $200,000 and $500,000: they lose more than half of the tax cuts they would otherwise have received, and more than 10 percent of them will receive no benefit at all from the Bush tax cuts in 2007 if Congress doesn't once again modify the AMT. As the number of people on the AMT increases through 2010, the AMT take-back also grows, to almost 28 percent (Leiserson and Rohaly 2006).

Table 3

Effect of the AMT on 2001-2006 Individual Income Tax Cuts, 2007[1]

Cash Income Class (thousands of 2006 dollars)[2]	Percent of Tax Units With No Cut Due to AMT	Percent of Tax Cut Taken Back By AMT	Percent of Tax Units on AMT[4]	
			Current Law	Pre-EGTRRA Law
All	1.4	19.1	15.7	6.8
Less than 30	*	*	0.0	0.0
30-50	0.1	0.3	1.2	1.3
50-75	0.5	1.8	8.9	6.8
75-100	2.3	11.1	36.2	18.1
100-200	6.3	34.0	70.8	23.4
200-500	11.7	55.3	89.7	41.3
500-1,000	1.3	16.3	57.1	22.0
More than 1,000	0.3	4.6	33.7	20.3

Source: Urban-Brookings Tax Policy Center
* Less than 0.05 percent.

(1) Calendar year. Tax cuts are calculated as a comparison of pre-EGTRRA law without the AMT and current law without the AMT. The share of the tax cuts taken back by the AMT is calculated using the increase in the AMT between pre-EGTRRA law and current law.
(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
(4) Includes those with direct AMT liability on Form 6251, those with lost credits, and those with reduced deductions.

It may seem odd that a household earning as little as $75,000 can be subject to the AMT—a tax designed to affect rich people. In fact, this can happen to households with very simple tax situations, as illustrated in the box. A married couple with four children earning $75,000 from wages and perhaps interest on a savings account would see their income tax more than double as a result of the AMT in 2007. They are on the AMT solely because they have four children. They don't take any special deductions. They get no benefit from the new 10 percent rate bracket or the higher standard deduction for couples enacted in 2001. They do, however, benefit from the higher child tax credit, if their children qualify, because that credit is allowed against both the AMT and the regular income tax (through 2010). They do not benefit from other personal tax credits, such as the child and dependent care tax credit or education tax credits, because those are not currently allowed against the AMT.

Box. A Couple with Four Children and $75,000 of Income on AMT in 2007

A married couple with four children under age 17 has an income of $75,000 from salaries and interest on their savings account. Under the regular income tax, the family can deduct $20,400 in personal exemptions for themselves and their children. They can also claim a $10,700 standard deduction. For the regular tax, their taxable income of $43,900 places them in the 15 percent tax bracket, and they owe $5,803 in taxes before calculating the AMT or tax credits. A child tax credit of $4,000 ($1,000 per child) is allowed against both the AMT and the regular income tax. Their regular income tax after credits would be $1,803.

To calculate AMT liability, the couple adds preference items—personal exemptions of $20,400 and the standard deduction of $10,700—to taxable income and subtracts the married-couple exemption of $45,000, yielding $30,000 in income subject to AMT. That amount is taxed at the first AMT rate of 26 percent, for a tentative AMT liability of $7,800. The AMT equals the difference between the couple's tentative AMT and their regular income tax, or $1,997. Thus, the AMT more than doubles this couple's taxes—from $1,803 to $3,800

AMT Calculation
Married couple filing jointly with four children, 2007

Calculate Regular Tax		**Calculate Tentative AMT**	
Gross income	$75,000	Taxable income	$43,900
Subtract deductions		*Add preference items*	
Personal exemptions (6 x $3,400)	$20,400	Personal exemptions	$20,400
Standard deduction	$10,700	Standard deduction	$10,700
Taxable income	**$43,900**	**AMTI**	**$75,000**
Tax before credits	**$5,803**	*Subtract AMT exemption*	
		AMT exemption	$45,000
Child tax credit	**$4,000**	**Taxable under AMT**	**$30,000**
		Tax (tentative AMT)	**$7,800**
Tax after credits	**$1,803**		
Tax bracket	15%	*AMT bracket*	26%

AMT = the excess of tentative AMT over regular income tax before credits
AMT = $7,800 - $5,803 = $1,997

Tax after AMT and credits = $1,803 + $1,997 = 3,800

Why the AMT is a Problem

Does it matter that the tax cuts threaten millions of middle-class families with the AMT? Yes. The AMT violates virtually every principle of tax policy. It is not fair: it penalizes married couples, includes nasty bracket creep (largely eliminated from the regular income tax in 1981, but still alive and well in the unindexed AMT), and disallows many legitimate deductions, such as certain legal fees. The AMT is inefficient: most taxpayers face higher effective marginal tax rates under the AMT than they would under the regular income tax—and that problem is getting much worse as more middle-income people (who face relatively low rates under the regular income tax) become subject to the AMT. The high tax rates discourage saving and working and encourage tax avoidance. And the AMT is hideously complex. It confounds taxpayers trying to comply with the law.

The recent practice of patching the AMT retroactively compounds the confusion. Right now, it is virtually impossible for the 23 million taxpayers who might become subject to the tax to predict their tax liability or whether they will be able to benefit from the various tax credits and deductions that are currently disallowed under the AMT. It all depends on whether Congress fixes the AMT and how it chooses to do so.

The only plausible defense for the AMT is that it is potentially a great revenue raiser. Because its parameters are not indexed for inflation, the AMT, over time, could become a money machine. The Congressional Budget Office has projected that if the AMT continues in its present form, tax revenues will increase from about 18 percent of GDP in 2005 to 24 percent by the year 2050. Personal tax revenues would nearly double.

Of course, these projections assume that almost everybody becomes subject to the AMT. That seems extraordinarily unlikely. Lawmakers have repeatedly scaled back the AMT to keep the number of its victims to a politically palatable 4 million or less, and this trend is sure to continue. The amazing revenue capacity of the AMT has gone almost entirely unrealized.

Indeed, one could argue that the AMT has damaged our fiscal situation by masking a large portion of the tax cuts enacted since 2001. In 2001, legislators understood that the AMT would take back a significant portion of the tax cuts and therefore keep their estimated cost within the tax bill's $1.35 trillion target.[7] As noted, the AMT is set to reclaim almost 20 percent of the individual income tax cuts in 2007 and 28 percent by 2010 barring a change in law.

But that would mean that 32 million taxpayers pay the AMT in 2010. That is unlikely to happen. If Congress continues to protect almost all taxpayers from the AMT, taxpayers

[7] House Ways and Means Committee Democratic staffer Al Davis (2000) pointed out the interaction of the president's proposals with the AMT a year before the legislation was considered by Congress. Larry Lindsey (2000), who advised the Bush campaign and later became a top economic adviser to the president, said that the failure to reform or eliminate the AMT was a matter of priorities given budget constraints: "Should additional revenue become available, reductions in the AMT might well be desirable." The logical corollary to that statement given the dramatic deterioration of budget projections since 2000—when large surpluses were anticipated—is that AMT reform should only occur in a fiscally responsible way.

will get much larger tax cuts than the Joint Committee on Taxation had projected. Put differently, the actual cost of the tax cuts will be much larger than budgeted.

And the AMT can undermine fiscal discipline one more way. Since members of Congress in both parties don't want to face the wrath of 23 million angry new AMT taxpayers, extending the AMT patch becomes a piece of "must pass" legislation as each Congressional session comes to an end. Savvy lawmakers know that they can attach less popular items to AMT extension and still be guaranteed a hefty majority. Although Congress has agreed to abide by PAYGO rules that require that any additional budget costs be offset, the support for AMT relief is so strong that PAYGO rules might fall by the wayside. (A 60-vote supermajority overrules them in the Senate.) Thus the recurring AMT relief could serve as a vehicle for new spending or tax cuts that are not offset by other spending cuts or tax increases.

What to Do about It?

There are many ways to reform or repeal the AMT in a fiscally responsible way and prevent it both from plaguing the middle class and from masking the cost of future tax cuts. The best approach would be to finance repeal of the AMT by broadening the tax base—for example, eliminate the deductibility of state and local taxes—rather than raising rates. Even better, AMT repeal could be part of fundamental tax reform, but there are obvious political challenges to either approach.

Some incremental options could also represent significant improvements. My colleague, Greg Leiserson, and I have suggested financing AMT repeal with a surtax that would apply only to high-income taxpayers (Burman and Leiserson 2007). It would be very simple for taxpayers to comprehend and comply with. The Ways and Means Committee majority staff has reportedly considered retargeting the AMT at those with very high incomes and offsetting the revenue loss through an additional income tax.

Any of those options would make the tax system more progressive than current law—that is, more of the tax burden would fall on the very high income households who were the AMT's original target. Other alternatives could be designed to mimic the distribution of current law. My colleagues and I have developed a smorgasbord of such plans (Burman, Gale, Leiserson, and Rohaly 2007) from which you might choose.

It is important, however, that any repeal or reform option be designed to be budget neutral, as the PAYGO rules require. Repealing the AMT without offsetting tax increases or spending cuts would drain federal tax revenues just as the baby boomers start retiring and demands on the federal government begin to swell. Outright repeal of the AMT without any other offsetting changes would reduce tax revenues by more than $800 billion through fiscal year 2017, *assuming that the 2001–2006 tax cuts expire after 2010.* If the tax cuts are extended, the revenue loss nearly doubles to almost $1.6 trillion.

This concludes my testimony. I'd be happy to answer any questions.

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Chairman RANGEL. That 800 million loss in revenue based on eliminating the AMT, this I'd assume that the President's tax cuts that are supposed to expire in 2010 has expired?

Mr. BURMAN. Yes it does. The cost doubles if the tax cuts are extended.

Chairman RANGEL. That would be over $1.5 trillion?

Mr. BURMAN. It would be almost 1.6 trillion, according to our estimates.

Chairman RANGEL. So, somewhere along the line, we need some economists to share with us, assuming the bill is revenue neutral, as to what is the best way to distribute the tax liability, either in the higher income people whose cut is expected to expire on 2010, or to take the same amount of moneys and have the middle class be able to enjoy the benefits of that cut. Is that basically where you end up?

Mr. BURMAN. Yes. One of the ironic things about the AMT, as Mr. Neal said, is that it actually doesn't affect very many people in the very, very highest income levels. You're actually more likely to be subject to the AMT if you earn between $75,000 and $100,000 than if you earned over a million dollars. It's an irrational tax system, especially given that it was originally designed to make millionaires pay some tax.

Chairman RANGEL. Of course, if you took in consideration changes in the child tax credit and the earned income tax credit, you could have an even more equitable distribution of the tax liability. Is that correct?

Mr. BURMAN. Sure.

Chairman RANGEL. Good. Director Furman from The Hamilton Project, Bookings Institute. Thank you for being with us again.

STATEMENT OF JASON FURMAN, DIRECTOR, THE HAMILTON PROJECT, BROOKINGS INSTITUTION

Mr. FURMAN. Thank you for having me again, Mr. Chairman, Mr. McCrery, Members of the Committee, to talk today about how to make our tax system more fair and equitable.

As you consider tax changes, I recommend keeping in mind three factors. First, the direct impact of tax changes on take-home pay. Second, the economic effects of tax changes on before-tax incomes. Third, how the associated budgetary changes will affect future taxes and benefits for working families.

Using an integrated approach, which I call dynamic distributional analysis, all three factors can be incorporated into a single variable—the change in the aftertax household income. My testimony today applies dynamic distributional analysis to assess the long-run economic impact of the 2001 to 2006 tax cuts on working families. The bottom line: My analysis shows that even if you assume the tax cuts help the economy, even if you assume they boosted incomes, even if you assume that they partly paid for themselves through that, when you take into account the financing of the tax cuts in the long run, 74 percent of families would be left worse off with lower aftertax incomes. If none of those rosy scenarios took place, it would be even worse.

Let me now walk you through the three steps in this analysis. First, the direct impact of the 2001 through 2006 tax cuts. Making

the tax cuts permanent would result in a 0.7-percent increase in aftertax incomes for the bottom quintile, and a 6.7-percent increase in incomes for the top 1 percent. That translates into an increase in aftertax income inequality.

Second, I turn to the impact of the tax cuts on the economy. Well designed tax cuts that are paid for without increasing the deficit can have a modest positive impact on growth. For example, Treasury studied the effects of making the tax cuts permanent under the unrealistic assumption that they were paid for with reduced spending. Their analysis concluded that the tax cuts could raise national output by an amount equivalent to raising the growth rate by 0.04 percent annually spread over 20 years. Picture that. Instead of the quarterly growth rate being 3.0 percent, it would be 3.04 percent, a change that would be barely perceptible in data on the economy.

The recent tax cuts, however, were enacted in conjunction with increases in spending and larger deficits. In this case, economic models generally show that the result of the higher debt is lower national savings, more foreign borrowing, less capital formation, and ultimately lower national income. Treasury itself found that given the current trends in fiscal policy, the sooner we eliminate the tax cuts, the higher national income would be.

Third, let's consider how the budgetary implications of the tax cuts affect families. Every official scoring agency and credible economist has consistently stated that tax cuts do not pay for themselves through stronger growth. At best, stronger growth may offset a small fraction of the cost of tax cuts. At worst, tax cuts lead to higher debt, lower savings, hurting the economy and magnifying their budgetary cost.

The recent revenue surprises do not alter this conclusion, especially since we have seen so many revenue surprises that go in the opposite direction, including positive revenue surprises following the 1990 and 1993 tax increases, and negative revenue surprises following the 1981 and 2001 tax cuts.

Tax cuts inevitably require reductions in government spending or increases in future taxes. In either case, their indirect budgetary effect serves to reduce disposable incomes by reducing government benefits or raising taxes. Although some of the costs could fall on future generations, much of them will fall on the very same household that receives the tax cuts today. For example, a person might get a $500 tax cut today but lose $700 in present value terms in future Medicare benefits.

Finally, although many analysts have considered these three channels in isolation, they should be combined together into a single, consistent assessment. Table 3 of my written testimony provides such an integrated assessment of making the tax cuts permanent. As you will see under the most optimistic assumptions, assuming that the tax cuts help pay for themselves, three-quarters of households would still end up with lower aftertax incomes if they were made permanent. This is because for most families, the tax cuts and modest boots to incomes are not nearly enough to compensate for the reduction in future government transfers like Social Security, Medicare and Medicaid.

As the old saying goes, there's no such thing as a free lunch. Cutting taxes for the most affluent almost inevitably results in long-

run reductions in the disposable income of working families. This lesson is confirmed by dynamic distributional analysis.

Thank you again for the opportunity to address this Committee. I look forward to your questions.

[The prepared statement of Mr. Furman follows:]

The Effect of the 2001-06 Tax Cuts on After-Tax Incomes

Jason Furman[1]
Senior Fellow and Director of The Hamilton Project
The Brookings Institution

Testimony Before the U.S. House Committee on Ways and Means
September 6, 2007

Mr. Chairman and other members of the Committee, thank you for the invitation to testify today at this hearing on fair and equitable tax policy for America's working families. I would like to start with a confession: as an economist I have no special expertise in fairness or equity. The members of this committee were elected, in part, to make critical value judgments about these fundamental questions. But in order to make these value judgments you need the understand who is impacted by the tax changes and how they are impacted. And economists do have a special expertise that can help further this understanding and thus inform the debate on the bigger issues.

Evaluating a tax change requires understanding the impact it has on households through three different channels: (1) the direct impact of the tax changes on take-home pay; (2) the economic effects of the tax change on before-tax incomes; and (3) the impact that the associated budgetary changes have on future taxes or government spending on households. All three channels can be usefully summarized in a single variable: the change in the after-tax incomes of households.[2]

Policy analysts and official scorekeepers have made varying degrees of progress on each of these three channels but have seldom integrated them into one comprehensive assessment of tax proposals. My testimony today applies such an integrated approach, potentially termed "dynamic distributional analysis," to examine the long-run impact of the tax cuts enacted from 2001 to 2006 on the after-tax income of American families.

Some of the key findings of this analysis are:

- **The direct effect of the tax cuts enacted from 2001-06 is to increase after-tax income inequality.** Ignoring the effects on the economy and the budget, making the tax cuts permanent would result in a 0.7 percent increase in the after-tax income of the bottom

[1] The views expressed in this testimony are those of the author alone and do not necessarily represent those of the staff, officers, or trustees of The Brookings Institution or the members of the Advisory Council of The Hamilton Project. Parts of this testimony draw on Furman, Summers, and Bordoff. 2007. "Achieving Progressive Tax Reform in an Increasingly Global Economy". Hamilton Project Strategy Paper. (June); Furman, Jason. 2006. "A short guide to dynamic scoring." Washington, DC: Center for Budget and Policy Priorities (August 24) and Furman, Jason. 2006. "Do Revenue Surprises Tell Us Much About The Cost of Tax Cuts?" Washington, DC: Center for Budget and Policy Priorities (July 18).

[2] A fuller analysis would consider the impact on the *welfare* of households, including not just after-tax income but also the impact on leisure and the time profile of consumption.

quintile and a 6.7 percent increase in the after-tax income of the top 1 percent. As a result, the gap between these incomes would grow.

- **Economic models generally rule out the possibility of a large, positive impact of the tax cuts on the economy and incomes.** In one favorable – but highly unrealistic – scenario the Treasury found that making the tax cuts permanent would be equivalent to raising the growth rate by 0.04 percentage points annually spread out over 20 years. In other words, the growth rate could rise from 3.00 percent to 3.04 percent – a change that would barely be perceptible in quarterly data on the economy. In more realistic scenarios the Treasury found the tax cuts would result in higher debt and lower savings – thus reducing long-run output.

- **Economic models show that the need to eventually finance the tax cuts could result in a large, negative impact on the disposable income of households, for example through reduced Social Security benefits, Medicare benefits, or higher future taxes.** This occurs because no economic model finds that tax cuts pay for themselves. The results of dynamic macroeconomic feedback show that the tax cuts are only slightly more expensive or slightly less expensive than shown by the official estimates that ignore such feedback.

- **Taken together, illustrative estimates show that even in the unrealistic best case scenario – in which tax cuts boost incomes and pay for part of their long-run cost through higher economic output – the financing costs of the tax cuts would leave 74 percent of households with lower after-tax incomes.** If the increased debt and reduced savings associated with the tax cuts leads to lower incomes, then 76 percent of households would end up with lower after-tax incomes.

The Context: Increasing Inequality

America has experienced a large increase in income inequality in recent decades. The changes have been particularly pronounced at the very top of the income distribution. In 1979, the earliest year for which data are available, the before-tax income of the most affluent 1 percent of the U.S. population already equaled that of the bottom 26 percent (Figure 1). That share has since risen nearly continuously, reaching 45 percent in 2004. Also in 2004, the top *one-tenth* of 1 percent had a before-tax income equaling the total income of the bottom 28 percent—a group 280 times larger in number. Several factors account for these shifts: primarily technological change that rewards skilled workers, but also declining unionization, the reduction in the real value of the minimum wage, increased immigration, and globalization more generally.[3]

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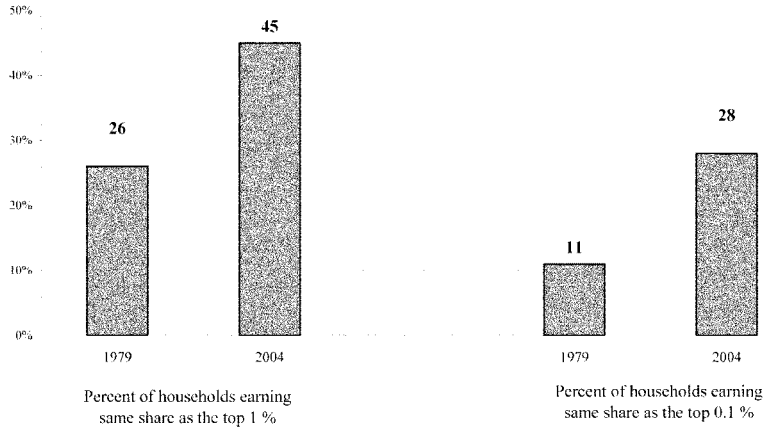
[3] See Autor, David H., Lawrence F. Katz, and Melissa S. Kearney. 2007. "Trends in U.S. wage inequality: Revising the revisionists." Revised from January 2004. http://post.economics.harvard.edu/faculty/katz/papers/AKK=ReStatRevision.pdf.; Acemoglu, Daron. 2002. "Technical change, inequality, and the labor market." *Journal of Economic Literature* 40 (march): 7-22; Card, David, Thomas Lemieux, and W. Craig Riddell. 2003. "Unionization and wage inequality: A comparative study of the U.S., the U.K. and Canada." Working Paper 9473. Cambridge, MA: National Bureau of Economic Research;

Figure1
Percent of Households at the Bottom of the Income Distribution Earning Same Share of Income as the Top Percentiles, 1979 and 2004



Sources: Authors' calculations based on Congressional Budget Office. 2006. "Historical effective federal tax rates. 1979 to 2004." Supplemental Tables. Washington, DC (December). www.cbo.gov/ftpdocs/77xx/doc7718/SupplementalTables.xls and Picketty. Thomas and Emmanuel Saez. 2007. Income Inequality in the United States. 1913-2005, Table A3: Top fractile income shares (including capital gains) in the U.S., 1913-2005 (March). elsa.berkeley.edu/~saez/TabFig2005.prel.xls
Note: Each bar represents the percentage of the income distribution, starting with the lowest-income household, whose combined incomes would just equal those of the top 1 or 0.1 percent of the distribution

One way to put these trends in perspective is to estimate the magnitude of the income shift implied by these numbers. From 1979 to 2004 the share of before-tax income going to the top 1 percent of income earners has risen by 7.0 percentage points while the share going to the bottom 80 percent of households fell by 7.4 percentage points (the share of income going to the remainder of the population – upper-middle-income families in the 80th through the 99th percentile – has remained roughly stable).[4] To fully offset the income shift in 2004 would have required transferring $664 billion from the top 1 percent of households to the bottom 80 percent—the equivalent of nearly $600,000 from every household in the top 1 percent and $7,000 to each household in the bottom 80 percent. No one would suggest this is feasible or even desirable, but it provides one potential benchmark for gauging the magnitude of the public policy interventions that would be necessary to address increases of inequality of this scale.

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and Levy, Frank, and Peter Temin. 2007. "Inequality and institutions in 20th century America." Working Paper 07-17. Cambridge, MA: Department of Economics, Massachusetts Institute of Technology.

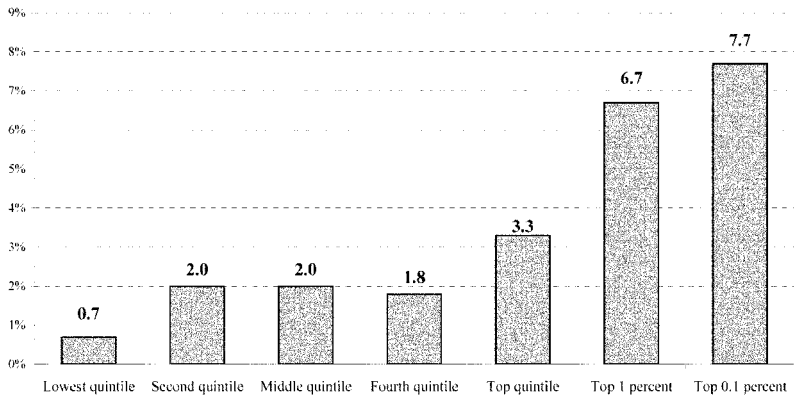
[4] For a family of four, the bottom 80 percent of families have incomes below $128,600 in 2004 and the top 1 percent have incomes over $533,600. Furman, Summers, and Bordoff,. 2007. "Achieving Progressive Tax Reform in an Increasingly Global Economy." Hamilton Project Strategy Paper. (June).

The Direct Impact of the 2001-2006 Tax Cuts: Widening Income Inequality

The direct impact of tax changes can be measured through the standard distributional tables prepared by the Joint Committee on Taxation (JCT), the Department of the Treasury, or outside organizations like the Urban-Brookings Tax Policy Center (TPC). In most cases the distributional analysis is largely a straightforward exercise in simulating the impact of tax changes on a representative sample of households using a relatively mechanical tax calculator. Estimates by JCT, Treasury, TPC, and others are generally relatively similar.[5]

Figure 2 shows the percentage change in after-tax income in 2017 assuming the tax cuts are extended. This is probably the best measure of the change in the relative well-being of different income groups.[6]

Figure 2
Effects of the 2001-2006 Tax Cuts Made Permanent
Percent Change in Income from Selected Income Groups When Tax Cuts are Fully in Effect in 2012



Source: Authors' calculations based on Urban-Brookings Microsimulation Model

[5] There is some academic debate over how to distribute the burden of corporate taxes to individuals. For this discussion, see Auerbach, Alan. 2006. "Who bears the corporate tax?" In *Tax policy and the economy*, vol. 20, ed. J. M. Poterba, 1-40. Cambridge, MA: MIT Press. But this debate is of little relevance to assessing the 2001-06 tax cuts because they included very little corporate rate cuts.

[6] Gale, William G, Peter R. Orszag. 2003. "The administration's proposal to cut dividend and capital gains taxes. *Tax Notes* 98 (3): 415-20 (January 20).

The bottom quintile sees a relatively small increase in its purchasing power, while the middle quintiles see a modest increase, and the top 1 percent see a very large increase. As a result the gap between the after-tax incomes of the top 1 percent and the bottom 20 percent widens from 99-to-1 to 104-to-1. In absolute dollars the discrepancies are even larger. In 2006 dollars the bottom quintile sees an $80 increase in its after-tax income, while the increase is $889 for the middle quintile and $79,713 for the top 1 percent.

Although taxes are still progressive they have done relatively little to offset the increase in inequality. As noted, since 1979 the share of before-tax income going to the top 1 percent has increased by 7.0 percentage points. Absent the tax cuts from 2001 through 2004 the corresponding after-tax income share would have risen by 5.6 percent, as shown in Table 1. Put another way, the progressive tax code would have automatically offset 20 percent of the increase in before-tax inequality. The tax cuts from 2001-06, however, undid most of this automatic stabilizer. As a result, the tax code offset less than 10 percent of the increase in inequality.

Table 1. Share of Income Going To Each Group

	1979	**1990**	**2004**	**Change from 1979 to 2004**
BEFORE-TAX INCOME				
Bottom 80 Percent	54.7	51.3	47.3	-7.4
Next 19 Percent	36.2	37.4	37.2	1.0
Top 1 Percent	9.3	12.1	16.3	7.0
AFTER-TAX INCOME (Actual)				
Bottom 80 Percent	57.9	53.8	51.0	-6.9
Next 19 Percent	34.9	36.3	36.0	1.1
Top 1 Percent	7.5	11.0	14.0	6.5
AFTER-TAX INCOME (Assuming no tax changes after 2000)				
Bottom 80 Percent	57.9	53.8	51.7	-6.2
Next 19 Percent	34.9	36.3	36.2	1.3
Top 1 Percent	7.5	11.0	13.1	5.6

Note: Incomes are adjusted for family size. For a family of four in 2004, the bottom 80 percent is below $128,600, the next 19 percent makes up to $533,600, and the top 1 percent makes more than that.
Source: Furman, Summers, and Bordoff. 2007. "Achieving Progressive Tax Reform in an Increasingly Global Economy." Hamilton Project Strategy Paper. (June).

These distributional estimates tell only part of the story because they ignore both the economic effect of the tax cuts and the fact that the tax cuts eventually need to be financed by some combination of future spending reductions or future tax increases. As a result, these results create the artificial impression that cutting taxes can raise incomes for everyone – a misleading result that comes from ignoring the "no free lunch" implication of the government's budget constraint.

The Economic Impact of the Tax Cuts: No Large, Beneficial Change

The second stage in the analysis of the impact of tax cuts on the after-tax incomes of households is to assess their impact on macroeconomic variables like national income and employment.[7] Although there is considerably less consensus on this issue than on the static distribution, every available modeling estimate rules out large, beneficial changes from the tax cuts enacted from 2001-06. Moreover, realistic estimates of the impact of tax cuts on the economy find that the higher debt and reduced national savings can reduce long-run national income and thus the before-tax incomes of households.

Assessing the economic impact of tax changes is complicated and somewhat uncertain for two reasons. First, estimates of the macroeconomic effects of tax cuts depend on the particular economic model being used and the specific parameters assumed for that model. For example, the impact of tax cuts depends critically on the poorly measured and somewhat controversial parameters that measure how much people's work and savings decisions change in response to changes in after-tax wages or rates of return. In the absence of a consensus on the correct model and parameters, official scorekeepers have been reluctant to provide a single, featured dynamic estimate.

Second, even if economists agreed about the correct models and parameters, there would still be a major hurdle in implementing and interpreting dynamic scoring: the economic impact of tax cuts depends critically on how and when tax cuts are paid for. In a sense, tax-cut proposals are incomplete and thus impossible to subject to dynamic scoring. For example, taken literally, making the 2001-06 tax cuts permanent would result in an explosion of deficits and debt that would last forever (on top of the already unsustainable fiscal situation). Not only is this impossible in reality, but it also makes it impossible to use modern economic models to estimate the macroeconomic impact of those policies.[8]

Economic models of the macroeconomic effects of tax cuts must reflect both the proposed policy and an assumption about how and when the policy will be paid for. Consequently, the results of these models often tell less about the proposed policy itself (e.g., making the 2001-06 tax cuts permanent) and more about the other policies that are assumed in the model (i.e., the assumptions about how and when the tax cuts will be paid for).

Generally, research has found that tax cuts that are not accompanied by other tax increases or spending cuts — such as the tax cuts in recent years — will increase the deficit, reduce national savings, and reduce economic output over the long run. This occurs because any economic benefits that tax cuts have in encouraging work and personal savings are more than

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[7] For more discussion see Furman, Jason. 2006. "A short guide to dynamic scoring." Washington, DC: Center for Budget and Policy Priorities (August 24) and Auerbach, Alan J. 2005. "Dynamic Scoring: An Introduction to the Issues." *American Economic Association Papers and Proceedings*, vol 95, no 2 (May).

[8] Modern economic models assume that individuals and businesses are forward looking, changing their behavior in response to expectations about future taxes, transfers such as Social Security, and government spending. Since an infinite explosion of the debt is impossible, individuals will not be able to decide how to behave without an assumption about the future policy changes that will be implemented to prevent an explosion of the debt. As a result, modern economic models cannot estimate even the *short-run* impact of a tax proposal without making assumptions about the full *long-run* policy.

offset by the economic cost of the larger deficits, which reduce national savings. In contrast, tax cuts that are paid for contemporaneously can contribute to economic growth, depending on their design. In neither case are the effects very large. (Note that dynamic scoring models do not address the possibility that cuts in government funding for research, education and other investments that could help pay for tax cuts might slow long-run growth.)

JCT used what economists call an "overlapping generations model" to examine the economic impact of a hypothetical 10 percent reduction in individual income tax rates. As shown in Table 2, in four of JCT's five financing scenarios, the tax cuts *reduced* long-term GDP.

Table 2. JCT Estimates of the Impact of a 10 Percent Income Tax Cut on Long-Run GDP
(Estimates Using an Overlapping Generations Model)

Financing Assumption	Impact on Long-Run GDP
Cut non-valued government spending after ten years	-0.04%
Cut government transfer payments after ten years	+0.10%
Increase tax rates on labor income after ten years	-0.10%
Increase tax rate on capital income after fifteen years	-0.43%
Cut government transfer payments after twenty years	-0.21%

Source: JCT, "Exploring Issues in the Development of Macroeconomic Models for use in Tax Policy Analysis," June 16, 2006, Table 3.

These results show that the longer you wait to pay for the cuts, the more negative the long-term economic effects. If, for example, Social Security payments are cut enough to fully pay for the hypothetical 10-percent rate reduction after ten years, the proposal would increase long-run GDP by 0.1 percent. But waiting 20 years would lead to larger government debt and *reduce* long-run GDP by 0.21 percent.

These same general principles apply to the tax cuts enacted from 2001-06. The Department of the Treasury conducted a dynamic analysis of the bulk of the tax cuts enacted starting in 2001.[9] One of their best case scenarios found that making the tax cuts permanent would result in a very modest economic gain (totaling 0.7 percent of national income – equivalent to a 0.04 percentage point increase in the annual growth rate spread over twenty years). Even this result was premised on the highly unrealistic assumption that the tax cuts were financed by a 1.3 percent of GDP reduction in all government spending starting in 2017, a sum equivalent to cutting domestic discretionary spending in half. The Treasury did not model more gradual and realistic reduction in spending but the generic modeling by JCT and others suggests that this scenario could well result in a reduction in economic output.

The Treasury study also estimated that if the tax cuts are financed by income-tax increases, they will reduce long-run national output by 0.9 percent. Under this scenario – if the large spending cuts do not materialize relatively quickly – the economic damage caused by the tax cuts would be minimized by reversing them more quickly. This is simply the corollary of a basic result in economics that it is better to finance a given level of government expenditures

[9] Office of Tax Analysis. 2006. "Dynamic Analysis of the Permanent Extension of the President's Tax Relief." U.S. Department of Treasury. (July 25).
http://www.ustreas.gov/press/releases/reports/treasurydynamicanalysisreporjjuly252006.pdf

with a "smooth" level of taxes.[10] For example, if the long-run budget is in deficit, it is better to act sooner and raise taxes by a smaller amount today than to wait for the deficits to grow so large that taxes have to be raised by a larger amount in the future. This is a basic implication of the old adage that it is better to act sooner to prepare for future challenges.

In no scenario were the economic benefits of the tax cuts so large that they would appreciably change the conclusions based on examining the tax cuts themselves and ignoring any economic effects. In some cases the economic harm caused by the tax cuts could result in even less favorable results than the static analysis would indicate.

The Budgetary Impact of the Tax Cuts: Negative and Potentially Large

The economic impact of the tax cuts has a relatively small impact on the disposable income of households that can be positive or negative. But the third channel in the analysis – the budgetary impact of the tax cuts – has an unambiguously negative impact on the disposable income of households. Moreover, this negative impact can be sizable relative to the income of low- and middle-income households – more than offsetting any direct benefits of the tax cuts or even the relatively unlikely possibility of stronger economic performance.

Tax cuts inevitably require reductions in government spending or increases in future taxes. In either case, this indirect budgetary effect serves to reduce disposable incomes, either by reducing government benefits or raising taxes. Although some of these financing costs will likely fall on future generations, many of them will fall on the exact same households that receive the tax cuts today.[11] For example, a person might get a $500 tax cut today but lose $700 in present value terms in future Medicare benefits.

It is common in dynamic analysis to explicitly specify how tax cuts are financed in order to calculate the impact of the tax cuts on economic performance. These same financing assumptions have major implications for the distribution of the tax cuts that should also be presented in these analyses.

The budgetary impact of tax cuts is negative because the tax cuts do not pay for themselves through stronger growth. Every official scoring agency and credible economist has consistently stated that tax cuts do not pay for themselves through stronger growth. For example, the 2003 Economic Report of the President stated, "Although the economy grows in response to tax reductions (because of higher consumption in the short run and improved incentives in the long run), it is unlikely to grow so much that lost revenue is completely recovered by the higher level of economic activity." Similarly, in an early edition of his leading economics textbook, N. Gregory Mankiw wrote that there is "no credible evidence" that "tax revenues … rise in the face of lower tax rates." He compared economists who say that tax cuts pay for themselves to a "snake oil salesman who is trying to sell a miracle cure."[12]

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[10] Barro, Robert J. 1979. "On the determination of public debt." *Journal of Political Economy* 87 (5): 940-71

[11] In fact, most of the dynamic analysis of tax cuts assumes that they are financed relatively quickly and not passed in significant measure onto future generations.

[12] N. Gregory Mankiw, *Principles of Economics* (Fort Worth, TX: Dryden, 1998), pp. 29-30.

Not only do tax cuts not pay for themselves, but depending on the specific policy dynamic effects can partially offset the cost of tax cuts or can partially augment the cost of tax cuts. For example, the Treasury's dynamic analysis of the tax cuts enacted since 2001 found that in the favorable case the dynamic effects of the tax cuts would offset 10 percent of their long-run cost while in the unfavorable case the economic harm from the added debt would add 13 percent to the long-run cost of the tax cuts.

In general, the conventional scoring – which includes microeconomic feedback but ignores macroeconomic feedback – is reasonably accurate. Former CBO Director Rudolph Penner, for example, recently commented that "for a very long time, the Congress will have to be satisfied with static scoring. That is not so bad. The CBO's dynamic analysis suggests that static scoring is usually pretty accurate." Nothing in the recent revenue surprises should lead us to alter this conclusion (see Box).

Do the Revenue Surprises Mean Tax Cuts Pay for Themselves?

The economy witnessed a series of large, positive revenue surprises following the tax increases in 1990 and 1993. All else being equal, these revenue increases would lead one to suspect that tax increases help the economy, perhaps by reducing debt and increasing national savings. This conclusion is strengthened by the observation that the economy witnessed a series of large, negative revenue surprises following the 1981 tax cuts – suggesting that dynamic effects magnify the conventional costs of tax cuts.* The same conclusion could be drawn from the experience of 2001-04. As the Congressional Research Service noted, "Actual tax receipts fell significantly more than predicted by the ex ante scores, even after controlling for economic conditions. This suggests that the tax cuts may have resulted in more revenue loss than predicted."† In contrast, the positive revenue surprises of the last three years would suggest the opposite conclusion.

But none of these experiences tells us very much for the simple reason that revenues are highly variable and fluctuate for numerous reasons that are unrelated to the dynamic feedback from tax cuts. Moreover, these dynamic feedbacks are expected to be relatively small and thus extremely hard to detect using the highly variable indicator of actual revenue levels.

Over the past 25 years, CBO's projection of the level of revenues that will be collected in the following fiscal year has been either too high or too low by an average of 6.1 percent, which is the equivalent of an overestimate or underestimate of $150 billion in fiscal year 2006. These projections have been just as likely to overstate revenues (i.e., to be too high) as to understate them. In contrast, even under optimistic assumptions the dynamic effect of the dividend and capital gains tax cuts enacted in 2003 would be predicted to be about $5 billion in fiscal year 2007 (20 percent of the $25 billion so-called static score). Even if true, an effect of this magnitude would be virtually undetectable when the underlying revenue numbers themselves are so volatile.

*This analysis is based on Furman "Do Revenue Surprises Tell Us Much About the Cost of Tax Cuts?" 2006
† Marc Labonte, "What Effects Have the Recent Tax Cuts Had on the Economy?" Congressional Research Service, updated April 14, 2006.

The Impact of the Tax Cuts on American Households

We can now assess the potential long-run impact of making the 2001-06 tax cuts permanent by combing the three factors discussed above. Specifically, after-tax incomes are affected by three factors:

1. The direct effect of the tax cuts is to increase after-tax incomes, with the largest increases (in both dollar and percentage terms) for the highest income households.

2. The indirect effect of the tax cuts on the macroeconomy can raise or lower average incomes depending on both the economic model and the financing of the tax cuts but these effects are unlikely to be large or important for most families.

3. The financing of the tax cuts generally lowers disposable incomes by reducing government transfers or increasing government revenues.

For illustrative purposes the following shows the effects of tax cuts under two scenarios. The first scenario gives the tax cuts the full benefit of the doubt, granting the Treasury's finding that under some circumstances the tax cuts could result in higher national output, resulting in both higher family incomes (by 0.7 percent) and partially offsetting the cost of the tax cuts (paying for 10 percent of them). This scenario assumes a large reduction in government consumption which, for the purpose of this illustrative distributional analysis, is modeled as a reduction in government transfers and thus a reduction in disposable income.[13] The second scenario assumes that large tax cuts are followed by even larger tax increases to recoup their cost – reducing economic output and magnifying the cost of the initial round of tax cuts.

Table 3 shows the impact of making the tax cuts permanent under these two scenarios, combining the direct effect of the tax cuts with the indirect effects on before-tax incomes and the assumed financing of the tax cuts.

[13] The Treasury model treats government consumption differently than government transfers, a distinction that is ignored here.

Table 3. Illustrative Dynamic Distributional Analysis of the 2001-06 Tax Cuts in the Long Run

	Static Tax Cut	Income Change	Finance Cost	Total After-Tax Income Change	Percent Change in After-tax Income	% with Income Increase	% with Income Decrease
Tax Cuts Financed By a Per Person Spending Reduction (Income increases by 0.7 percent and tax cuts pay for 10 percent of themselves)							
Bottom Quintile	$79	$55	$1,576	-$1,442	-12.1%	0%	100%
Second Quintile	$546	$119	$1,576	-$911	-3.3%	8%	92%
Third Quintile	$887	$219	$1,576	-$470	-1.1%	22%	78%
Fourth Quintile	$1,275	$358	$1,576	$57	0.1%	44%	56%
Fifth Quintile	$6,763	$957	$1,576	$6,243	3.0%	57%	43%
Top 1%	$84,582	$7,576	$1,576	$90,581	7.7%	99%	1%
All	**$1,939**	**$339**	**$1,576**	**$701**	**1.0%**	**26%**	**74%**
Tax Cuts Financed by Future Tax Increases (Income falls by 0.9 percent and tax cuts cost 13 percent more than expected)							
Bottom Quintile	$79	-$72	$54	-$48	-0.4%	19%	63%
Second Quintile	$546	-$160	$294	$91	0.3%	32%	58%
Third Quintile	$887	-$294	$936	-$344	-0.8%	26%	72%
Fourth Quintile	$1,275	-$525	$2,219	-$1,470	-2.0%	10%	90%
Fifth Quintile	$6,763	-$1,921	$8,811	-$3,871	-1.9%	5%	95%
Top 1%	$84,582	-$11,401	$56,630	$16,551	1.4%	43%	57%
All	**$1,939**	**-$592**	**$2,467**	**-$1,120**	**-1.6%**	**19%**	**76%**

Note: Income change column includes interaction effect with tax cuts. Winners and losers do not total 100 percent because after-tax income is unchanged in some cases.
Source: Very preliminary estimates using the Urban-Brookings Tax Policy Center Microsimulation Model.

In both scenarios roughly three-quarters of households end up with lower after tax incomes. As the Treasury study and others have pointed out, financing tax cuts with spending reductions is more efficient on average – resulting in higher average incomes rather than lower average incomes in the scenario where the tax cuts are financed by future tax increases. The flip side is that the spending reduction scenario is substantially more regressive, with the large majority of the bottom 80 percent of households witnessing reductions in their after-tax incomes. For the bottom quintile these reductions average 12 percent of after-tax income. In contrast, the other scenario assumes a more progressive funding source for the tax cuts and thus has somewhat fewer middle-class losers. Finally, if the goal of policymakers is to minimize the number of losers both scenarios are inferior to not having the tax cuts in the first place, in which case there are no losers.

Conclusion

The analysis in this testimony contains two important conclusions. The first conclusion is analytic: CBO, JCT, Treasury and academic researchers should begin to conduct "dynamic distributional analyses." A number of researchers have conducted dynamic analyses of tax cuts that are premised on specific assumptions about the financing of tax cuts. These dynamic

analyses should also present information on the distributional impact of these tax cuts using the same financing assumptions employed in the efficiency analysis. As a general matter, such analysis would often show that tax cuts that appear to result in substantial efficiency gains are also likely to be highly regressive and possibly even harmful to much of the population.[14] Ultimately such analyses offer the hope of telling policymakers what they should really care about in evaluating tax policies: how will it affect the after-tax income of various income groups in society.

The second conclusion is specific to the tax cuts enacted from 2001-06. By themselves these tax cuts have exacerbated after-tax income disparities, thus resulting in more inequality. A more complete analysis that incorporates the economic and budgetary effects of the tax cuts finds that even in the unlikely scenario in which the 2001-06 tax cuts boost incomes and help pay for themselves, 74 percent of households are made worse off. In the potentially more realistic scenario that tax cuts are paid for with future tax increases 76 percent of households are made worse off, although the harm for low- and moderate-income families is relatively small compared to the "optimistic" scenario. This finding does not imply any specific stance towards the tax cuts. But it reinforces that there is no free lunch because ultimately the government faces a budget constraint. As a result, reducing taxes for the most affluent households almost inevitably results in long-run reductions in disposable incomes for working families.

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[14] For example, the Mankiw-Weinzierl model referred to above assumes that tax cuts are paid for by simultaneous increases in lump-sum taxes or reductions in government transfers like Social Security, Medicare, Medicaid and food stamps.

Chairman RANGEL. Thank you so much.

Douglas Holtz-Eakin, Senior Fellow, The Peterson Institute, and someone that has provided invaluable service to the Congressional Budget Office and the Congress, welcome back.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, SENIOR FELLOW, THE PETERSON INSTITUTE, AND FORMER DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman, Mr. McCrery and Members of the Committee. It's a privilege to be here today. I've submitted a relatively long statement for the record. Let me take a few moments to make really three basic points about assessing the status of the U.S. Tax Code.

Point number one is that it is the job of the Tax Code to raise funds to finance spending. It exists only for that purpose. In that regard, the Tax Code is currently doing pretty well. For fiscal 2007, the CBO projects that the Federal Government will raise 18.8 percent of GDP in revenues, above the typical amount in the past 40 years. The Federal Government will spend about 20 percent of GDP in Federal spending, a touch below the average for the past 40 years, and the result will be a deficit of 1.2 percent of GDP, a bit lower than the typical performance of the Federal Government.

So, in terms of paying the bills——

Chairman RANGEL. Excuse me. Are you including defense spending in that?

Mr. HOLTZ-EAKIN. It's the CBO projection for the unified deficit, all revenues, all spending. So, that's for fiscal year 2007. Now we know it hasn't been doing quite that well in recent years. Deficits have been larger, but we've seen quite rapid revenue growth in recent years. We've seen double-digit growth in some portions of tax receipts. Notable portions are corporate income taxes and capital gains taxes. I don't think it's sensible to project that we'll get double-digit growth forever, but there doesn't appear to be any pervasive problem in raising revenue out of this Tax Code.

Going forward, the major focus will be on the spending side, where as is well known to this Committee, we will see Social Security, Medicare and Medicaid rise under current trends to a size that's comparable to the current entire Federal Government—20 percent of GDP—if we get good news in the health programs. If we don't, it will be larger yet.

How will this play out? One possibility is we'll borrow money until credit markets say no and leave our kids with a very large bill. Another possibility is we'll try to raise taxes by 50 or 75 percent above their current levels and cripple this economy regardless of whether you're a "supply sider" or not. In either case, we will leave to the next generation a burden that is inappropriate, and that is the most pressing fairness issue facing this government, it's the most pressing fairness issue facing this Committee, which has jurisdiction over all those pieces that are the key components of the fiscal challenge.

So, right now we're doing okay, but going forward, we must control the spending, and that's the central fairness issue that we face.

The second part of the review would be to look at the ability of the Tax Code to raise revenue without additional extra costs, and

there I can't say that we're doing so well. Everyone who looks at the regular Tax Code and then adds on the alternative minimum tax comes to the conclusion that the U.S. income tax is a Byzantine, complex morass that most individuals simply cannot navigate. The President's tax panel put a price tag on the cost of this and said that it imposes an extra $140 billion per year—a thousand dollars for every man, woman and child—in just complying with the Tax Code. We clearly can do better and not impose an extra burden on the families of the United States in raising our revenue.

A second cost, typically hidden, is the cost that the Tax Code imposes in the form of economic distortions; changing the way markets and families would like to do their business just for tax purposes, and a lot of financial engineering that we hear so much about. These are big costs to an economy that needs to grow to face the burdens of the baby boom, and that needs to be internationally competitive. If you look at the double tax on saving, if you look at the extra taxation on some forms of business, you look at the differential taxation of fringe benefits, you look at all sorts of high marginal tax rates, particularly for low-income individuals, this is a Tax Code that has compliance burdens and efficiency burdens that should be reduced, and it's not doing very well on that front.

The last part is fairness. As the written testimony says, there are lots of complications in assessing fairness. So, the caveats are, one, we don't have an agreed-upon consensus on what fairness means. Two, we must distinguish between who sends in the check and who bears the economic burden of a tax, the genuine incidence. Three, there's lots of competing measures.

I'll simply touch the high points, which is you can imagine a neutral system being one where we tax you equal to what you get back from the government, and you can look at the current tax system where low-income individuals, 40 percent of which pay no income tax, receive back benefits, so there's a redistribution toward them. High-income individuals who pay the vast majority of income taxes, do not receive back benefits comparable to that, and so we have a system that is by any measure in the large a progressive tax system that redistributes toward those at the lower end of the income distribution.

The second part of fairness would be do we treat equal taxpayers equally? The answer is no. We treat people with the same lifetime incomes who save and tax them more heavily than those who do not. We treat renters less generously than we do people who buy their homes. We treat people who pay equity in their homes less generously than those who borrow. We treat people who receive their services through state and local governments more generously than those who do not. The list goes on and on.

So, we have a system that is meeting our revenue needs, but will not in the future unless we come to terms with our spending problem. That's the primary problem on fairness. We also have a system for any given level of revenue has severe impacts on our ability to grow and compete and doesn't meet the standard of fairness. We could use a much better Tax Code.

Thank you. I look forward to the chance to answer your questions.

[The prepared statement of Mr. Holtz-Eakin follows:]

Prepared Statement of Douglas Holtz-Eakin, Senior Fellow, The Peterson Institute, and Former Director, Congressional Budget Office

Chairman Rangel, Ranking Member McCrery, and Members of the Committee, thank you for the opportunity to participate in this important hearing. The topic of tax fairness raises myriad issues. In my comments today, I will focus on only a subset of the possibilities.

1. Objectives of Tax Policy

Paying the bills. The central purpose of the Tax Code is to raise revenue to finance Federal outlays. According to the Congressional Budget Office (CBO), for fiscal 2007 total revenues will be nearly 19 percent of Gross Domestic Product (GDP)—above the average for the past 40 years—yet fall below total Federal spending equal to about 20 percent of GDP.[1] The resulting unified budget deficit of 1.2 percent of GDP lies well within the range of historical budget outcomes.

Unfortunately, in the years to come mandatory spending programs will grow quite rapidly.[2] The rising fiscal pressures emanating from spending on Social Security and health programs, if left unchecked, will threaten the three pillars of U.S. postwar economic success. First, the successful U.S. economic strategy has been to rely largely on the private sector; the mirror image of this approach being a government sector that is relatively small (granted, "small" is in the eye of the beholder) and contained. Growth in spending of the magnitude promised by current laws guarantees a much larger government.

Second, the small U.S. Government has been financed by taxes that are relatively low by international standards and interfere relatively little with economic performance. Spending increases of the type currently projected would entail taxes higher by 50 percent or more to unprecedented levels. Such a policy would impair economic growth and reduce living standards for future generations.

Finally, a hallmark of the U.S. economy has been its ability to flexibly respond to new demands and disruptive shocks. In an environment where old-age programs—namely Social Security, Medicare and Medicaid—potentially consume nearly every budget dollar, to address other policy goals future politicians may resort to mandates, regulations, and the type of economic handcuffs that guarantee lost flexibility.

In sum, the ability of the Tax Code to meet its primary objective is most threatened by the absence of reforms to mandatory spending programs. This raises the specter of a generational injustice: bequeathing to our children and grandchildren a rising burden of taxation, a less robust economy, or both. The most pressing issue of fairness cannot be addressed by raising taxes, but rather requires reducing the growth of spending.

Keeping the burden of taxes low. The importance of keeping Federal spending contained to national priorities and thus permitting taxes to be as low as possible is straightforward: taxes directly reduce the ability of families to pay their bills and save for the future. However, even the best tax system impairs market incentives, imposes obstacles for households and firms alike, and undermines economic performance. A goal of tax policy should be to keep such interference and waste as small as possible.[3]

In this regard, unfortunately, our Tax Code is in need of a major overhaul. A vivid example of the type of distortion our Code presents is provided by health insurance. At present, employer-provided insurance is not treated as part of income so companies offer health insurance coverage as a tax-free benefit instead of higher wages or salaries. Employees and employers alike respond to the tax-based incentives and change compensation packages. The result is less revenue (and the need for higher tax rates elsewhere). The flip side of the coin is demand for more and more generous insurance which drives up insurance costs. In some cases, individuals go without insurance as a result. If individuals purchase insurance themselves, they do not receive the same tax treatment as when their employer purchases for them, generating biases in health insurance markets. In short, a poorly-designed Tax Code exacerbates our pressing health insurance issues.

The provision of health insurance is just one of a multitude of economic decisions within our $13 trillion economy. Tax-based distortions permeate our daily economic lives. Decisions on saving, retirement, education, investment, debt and equity fi-

[1] Congressional Budget Office, The Budget and Economic Outlook: An Update, August 2007, p. xi.

[2] See Congressional Budget Office, The Long-Term Budget Outlook, December 2005.

[3] This loss is sometimes referred to as the "efficiency cost," "deadweight loss," or "excess burden" of the tax system and captures the reality that there is a loss to households above and beyond the amount of tax revenue collected.

nance are driven by tax-based planning to the detriment of our ability to meet pressing national needs. The Tax Code is a basic impediment to the United States' ability to grow robustly and compete in global markets.

The loss in economic performance is exacerbated by the sheer cost of complying with an overly complex Tax Code. According to the President's Advisory Panel on Federal Tax Reform, "If the money spent every year on tax preparation and compliance was collected—about $140 billion each year or over $1,000 per family—it could fund a substantial part of the Federal Government, including the Department of Homeland Security, the Department of State, NASA, the Department of Housing and Urban Development, the Environmental Protection Agency, the Department of Transportation, the United States Congress, our Federal courts, and all of the Federal Government's foreign aid."[4]

Fairness. A final objective is to raise taxes in a fair fashion. Unfortunately, there are two major obstacles to an easy evaluation of the success in meeting this standard. The first is figuring out who really pays a tax.[5] For example, in 2006 the Federal Government raised $354 billion from the corporation income tax. However, corporations did not "pay" the tax in any meaningful sense—they merely sent in the check. In the process of meeting their tax obligation, however, firms could have raised prices, cut back on wages, reduced fringe benefits, slowed replacement of equipment or scaled back expansion plans, cut dividends, or many combinations of their options to alter their revenues and cost structures. The result is that the corporation tax is "paid" by customers, workers, or investors. Indeed, recent evidence suggests that the relatively high rate of the U.S. corporation income is ultimately paid by workers in the form of lower wages.[6]

A second difficulty is the absence of an ethical consensus on distributional fairness. In the absence of such benchmark, two guidelines prove useful. The first is to note that individuals view market transactions as a "fair deal" when they get back value equal to what they paid. By analogy, a benchmark for judging the tax system is whether a taxpayer's liability is equal to benefits received from the Federal budget—a neutral system. If benefits received exceed taxes, the household is a net beneficiary of the tax system and *vice versa*.

This perspective differs from two other metrics that are commonly employed—effective tax rates and tax shares. Effective tax rates are the ratio of taxes paid to income—roughly the share of income taken by taxes. A drawback to evaluating fairness using effective tax rates is that the rates may change because of movements in the denominator—families' incomes—that have nothing to do with tax policy. Incomes are influenced by taxes, but also are determined by skills, education, effort, risk-taking and innovation, regulations, and other factors. Tax shares—the fraction of the overall taxes that each individual pays—have the drawback that they ignore the spending side of the equation. Given that taxes are necessary only because of spending, this omission is striking.

Viewed from this perspective, the U.S. Tax Code is highly progressive—lower income individuals receive much more than they pay in taxes. According to the CBO, the bottom 40 percent of the income distribution paid no Federal income tax in 2004.[7] Of course there are other taxes. In particular, payroll taxes are the largest tax for a majority of households. But examining the payroll tax is ultimately a reminder of the need for social security reform. The progressivity of this programs will depend upon the scale of the benefits individuals receive in the future.

A second perspective on fairness stems from the fact that the Tax Code assigns taxpayers with the same income, number of children, and other factors different tax burdens. As noted above, taxes will differ depending on whether a family purchases health insurance or receives it as part of an employer compensation package. Two families with the same income will pay different taxes because they reside in different states, and some families receive state-provided services for which they can deduct income and property taxes. A person who saves more of their earnings in taxable accounts will pay more in taxes than a non-saver who has the exact same earnings year by year. Indeed, some inequality may stem from the sheer complexity of the Tax Code and the inability of individuals to take advantage of tax benefits for which they are eligible. These differences between otherwise similar taxpayers are at odds with basic fairness and undermine faith in the fairness of the Tax Code.

Summary. The most pressing tax fairness issue facing the United States is the potential for dramatic tax increases, slower income growth, and reduced standards

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[4] See the final report at http://www.taxreformpanel.gov/final-report

[5] This is referred to as determining the economic incidence of a tax.

[6] See Kevin Hassett and Aparna Mathur, "Taxes and Wages," AEI Working Paper #128, 2006.

[7] See Congressional Budget Office, Historical Effective Tax Rates: 1979 to 2004, December 2006.

of living for future generations if the spending growth profile of the Federal Government is not reduced. All other fairness issues pale by comparison.

At present, the Federal tax system is roughly achieving its goal of providing financing for Federal spending. However, there is little else to defend in the current Tax Code. It is overly complex and burdensome, interferes too much with commerce and economic competitiveness, and is riddled with uneven treatment. Far-reaching reforms are merited; more modest efforts will not succeed in raising Federal revenues in a pro-growth and fair fashion.

2. Recent Issues in Tax Policy

In recent years, there have been numerous changes in Federal tax laws which has, in turn, spawned vigorous discussion regarding tax policy.

Recent Trends in Tax Receipts. Table 1 shows total Federal revenues and key components over the period 1996–2006. As the table makes clear, Federal receipts are currently growing quite rapidly. Total receipts have grown at 14.5 percent and 11.8 percent in fiscal 2005 and 2006, respectively; a pace that exceeds the celebrated revenue surge of the 1990s that drove the Federal budget to balance. Individual income tax receipts are also rising at rates above those from the earlier period, driven in part by growth rates of capital gains receipts equal to 21 percent, 38 percent, and 23 percent in the years 2004–2006. Even more striking has been the very rapid increase in corporation income tax receipts, which hit a recent peak growth rate of 47 percent in 2005. Such rapid growth cannot, of course, be sustained indefinitely when the underlying economy is growing at 5–6 percent per year. However, the evidence to date suggests that the current tax system is generating adequate revenue growth.

Tax policy and economic growth. Overall GDP growth fell dramatically in 2001 (0.8 percent) and 2002 (1.6 percent) as the economy suffered a recession and weathered the impact of terrorist attacks, corporate scandals, and higher energy costs. Since that time, annual GDP growth has averaged 3 percent and solid growth in payroll employment has resumed. Most analysts credit the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRAA) with mitigating the extent of the falloff in economic growth, largely because its passage very nearly coincided with the economic downturn.

It is best, however, to view this timing as fortuitous and not as a signal that future Congresses should attempt to engage in fiscal "fine-tuning" that attempts to counter the inevitable business cycles of the future. Instead, it would be preferable for tax policy to focus on promoting robust, long-term economic growth. What would such a Tax Code look like?

Consumption-based taxation.[8] A consumption tax is just what it sounds like: a tax applied to consumption spending. However, under that deceptively simple umbrella resides a vast array of potential variants. Consumption taxes can be flat or contain multiple rates; can be applied to households, firms, or both; and can be viewed as "direct" or "indirect" taxes.

For purposes of my remarks today, let me focus on a few identities that give the flavor of the issues. For a household—or the country as a whole—all income (Y) is either consumed (C) or saved (S): Y=C+S. This suggests two broad strategies for taxing consumption. One is to tax consumption (C) as in a national sales tax. The alternative is to tax it "indirectly" by levying the tax on "consumed income"—income after deducting saving or investment: (Y–S). This is the strategy taken by a value-added tax (VAT), the Hall-Rabushka flat tax, or the "X-tax", a more progressive variant of the Hall-Rabushka tax developed by the late David Bradford.

Interest in a U.S. consumption tax is not new. Advocates have touted the potential benefits from moving to a consumption tax for many years. However, I wish to separate my support from some of the more overreaching arguments. In particular, my support for a consumption-based tax reform is not about:

1. Simplicity. Some consumption taxes—notably the original Hall-Rabushka flat tax—have been publicized on the basis of their "simplicity." Who can forget (admittedly tax economists have a limited reservoir of thrills) the first time they saw the Hall-Rabushka postcard tax return? Similar simplicity arguments have been made about a national retail sales tax, where advocates tend to argue that there is little to do except piggyback on existing state efforts.

But this really misses the point for three reasons. First, no tax system will be that simple. For any household, the goal is to legally minimize its tax liability. The innate craftiness of the American populace will dictate that any tax system will acquire a growth of rulemaking that delimits the boundaries of acceptable behavior.

[8] This section draws on Douglas Holtz-Eakin, "The Case for a Consumption Tax," *Tax Notes,* October 23, 2006.

That is, a certain amount of complex rule-making will be necessary. A common complaint of income-tax defenders is that consumption tax folks compare an ideal consumption tax with the actual income tax. This is truly unfair and no way to decide between the two. Second, as noted above, for many there is nothing simpler than the current income tax—they don't pay it. As is becoming more widely appreciated, the current income tax is not your father's income tax. Complexity of the income tax is the curse of those who pay it. Third, postcards are obsolete. Today your taxes are "done"—that is computed—by tax-preparation software and filed on-line.

2. Making taxes more or less visible. A common argument supporting a national sales tax is that it would make more visible the cost of government. Perhaps, but the ultimate measure of the size of government is its spending. Once the dollars have been committed, the taxpayer will pay one way or the other. Either taxes will be levied to match the spending, or there will be borrowing to cover the Federal deficit. It may be important to raise the visibility of Congressional decisions, but putting taxes on your register receipt does not display spending. Indeed, if a national sales tax did produce pressure to keep taxes low, it may do nothing to address the tsunami of future Medicare spending and lead to larger deficits.

3. Raising the national saving rate. A consumption tax would remove the tax-bias in favor of current consumption, and many believe that this would raise the private saving rate. If so, then good. The main idea is to eliminate tax-based financial decisions and have households choose based more on the economic fundamentals. However, I suspect that the scope for dramatic changes is somewhat limited. Instead, the most rapid improvement in the national saving rate will come from controlling Federal spending and thus reducing government borrowing.

Instead, a consumption tax meets the following needs of the tax system:

1. The philosophical foundation of the Tax Code. Public policies should mean something. As I have stressed, the Tax Code exists for a single purpose: it exists to finance the costs of public programs. The powerful behavioral effects of taxation are real, and a tribute to the power of market incentives as the mechanism by which taxes influence behavior is to change prices. Since the purpose of the Tax Code is to raise revenue, it has as its core mission reducing the resources of some households. The central question is why choose those who consume over those with income. Consumption is the spending that extracts resources from the economy. In contrast, saving is economic activity necessary to contribute to a growing economy. Recall the identity: Y=C+S. An income tax treats identically those high-income individuals who live frugally and plow their resources back into the economy and those that spend every night drinking champagne in a limousine while hopping from club to club. Taxing consumption reduces the burden on the former, while focusing it on the latter.

2. Economic efficiency. A consumption tax would reduce the extent to which economic activity is dictated strictly by reducing taxes (an unproductive use of time and money). First, it broadens the tax base to include all consumption. The essential recipe in any tax reform is to broaden the tax base and lower tax rates. Specifically, the base would include the consumption of employer-provided health insurance (currently entirely untaxed) thereby correcting a major inefficiency that feeds health spending pressures. In addition, it would eliminate the current deduction for state and local taxes, thereby including consumption provided by sub-Federal Governments. Thus, it would improve the allocation of consumption spending across sectors.

A consumption tax would not distort household choices in the timing of consumption—after all you would either pay the tax now or pay it later. In contrast, under an income tax households pay at both times if they choose to save and consume later. A consumption tax would equalize the tax treatment of investments in physical capital, human capital, and intangible capital. At present, the firm purchases of the latter two types of investment are "expensed" (immediately deducted), while physical capital expenditures are depreciated. Moreover, by eliminating the deduction for mortgage interest, the allocation of physical capital would be improved as business investments would compete on a level playing field with the construction of housing.[9]

A desirable feature that is difficult to quantify is the impact on entrepreneurs. Entrepreneurial forces are widely acknowledged to be important to the success of the United States, but tax policy is rarely formulated with an eye to their incentives. For example, entrepreneurial ventures develop a scale and financial structure dictated by market conditions. In contrast, the Tax Code interferes with these incen-

[9] For estimates of the long-run impact on economic growth, see "Simulating Fundamental Tax Reform in the United States" by David Altig, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters, and Jan Walliser, *American Economic Review*, 574–595.

tives—extracting a double tax on equity in "C corporations", subsidizing leverage, and thus distorting the choices of business form and financing. The flat business-level tax does not depend on financial structure—it is focused on "real" business transactions—and yields the same liability regardless of legal organization.

3. Acknowledgment of reality. Our current income tax is an exercise in fantasy. An important part of its administration is the taxation of the return to capital. To be successful, this requires that capital income—interest, dividends, capital gains, rents, royalties—be comprehensively measured and adjusted for depreciation and inflation. There is no reason to believe that the U.S. is even moderately successful in this effort, or that the continuing maturation of global financial markets will make it anything but less successful in the future. A consumption tax focuses the tax base on real economic activity—not financial transactions. This is an important difference in a world in which global financial markets have made if virtually impossible to tax capital income, and an excessive regulatory and enforcement regime has grown up around attempts to do so. Instead, the consumption tax focuses on "taxing at the source" before business income enters into financial markets and ultimately is paid to investors.

Specifically, the X-tax (along with the VAT or flat tax) would impose a single-rate business-level tax on a base that consisted of total receipts minus the sum of purchases from other firms and employee compensation. Implicit in those receipts is the contribution of capital, which is taxed prior to distributions in the form of dividends or interest.

4. Fairness. Because a consumption tax is neutral regarding the timing of consumption, it does not penalize those patient households that save their income for a greater lifestyle later in life. That is, two households with the same lifetime income will pay the same lifetime taxes. More generally, consumption taxes may be designed to achieve conventional distributional goals. To begin, under the X-tax, households are taxed on the basis of comprehensive employee compensation. However, such a system would include a generous exemption for a basic standard of consumption and a progressive rate structure.

A concern often raised is that taxing compensation permits high-income individuals to "avoid" tax on their capital income. However, an appropriately-designed consumption tax includes the vast majority of such earnings in its base. In the X-tax, saving and investment is immediately tax-deductible or expensed, but all principle and interest is taxed in the form of revenues at the entity level. Mechanically, this differs from an income tax only by the fact that under an income tax the saving and investment would be depreciated and not expensed. That is, the two approaches differ only by the timing of tax receipts to the U.S. Treasury—less up front for the consumption tax because of expensing, but more in later years because there is no ongoing stream of depreciation. Accordingly, the two tax bases differ only by the return to Treasury securities—the least risky and lowest rate of return. All additional returns—accruing from risk, monopoly power, luck, and other sources—are included in the tax base of both tax systems. Since these types of capital returns are responsible for the largest differences in incomes and consumption tax would capture these in the base, the distributional consequences of such a consumption tax would be in accord with U.S. tradition.

JGTRAA and pro-growth taxation. Viewed from this perspective, the 2003 Jobs and Growth Tax Relief Reconciliation Act is an important step. Reduced taxation of corporate equity returns reduces the bias toward debt finance, lowers the misallocation of capital in the economy and, combined with partial expensing of some investments represents a step toward a more efficient Tax Code. An impediment to fully realizing the potential of this improved tax policy, however, is the fundamental uncertainty over the future of the Tax Code. Eliminating this uncertainty, keeping taxes low and efficient, would benefit overall economic performance.

The Alternative Minimum Tax. The Alternative Minimum Tax (AMT) has attracted attention in recent years because of the growing number of taxpayers who are projected to become liable for the AMT, the fact that the most affluent of taxpayers are longer exclusively the payers of the AMT, and the fact that most additional taxpayers will become liable for the AMT because the effects of inflation. Thus, in the narrow the major tax policy issue is the failure of Congress to index the AMT.

Viewed from a broader perspective, however, the AMT raises larger issues. To begin, although some argue that the AMT is a better tax because it has a broader base (achieved by disallowing exemptions and deductions) and only two relatively low statutory rates, this is misleading. From an equity standpoint, there is a long history of acknowledging the impact of family size on tax liability and the AMT does not. From an economic efficiency standpoint, the key issue is that effective marginal tax rates are not always than the regular tax's marginal rates; sometimes, they are

actually higher. A large portion of the AMT's lower rates reflects the tax-free threshold's zero rate. Once the AMT kicks in, the marginal rate jumps to 26 percent, well above the regular system's 10 to 15 percent. The highest marginal rate under each system is the same—35 percent.

The more general problem is that the very presence of the AMT is an indictment of the basic Tax Code. It should be the case that a single Tax Code can be designed to raise needed revenues, while meeting sensible criteria for simplicity, fairness, and economic growth and competitiveness. Attempts to "fix" the AMT by modifying tax brackets, rates, or deductions will not address this fundamental problem. A more desirable approach would be to eliminate the AMT entirely, but do so in the context of a broader revamping of the Tax Code.

Tax policy and the distribution of economic well-being. While recent U.S. GDP growth has been robust and payroll employment growth sustained, concern has arisen that growth is not translating into acceptable increases in standards of living for too many American households. This has generated a further concern that pro-growth tax policy per se is responsible. The facts, however, suggest otherwise. The dominant source of change in the income distribution is a long-term trend in the wage structure in the U.S., and not recent changes in tax policy. To the extent that policymakers wish to address this issue, the most fruitful approaches involve improving K–12 educational outcomes, thereby equipping future workers with better skills and the ability to be successful in college.

A large literature in labor economics documents a substantial widening of the U.S. wage structure during the 1980s.[10] Wage differentials by education, by occupation, and by age and experience group all rose substantially. The growth of wage inequality was reinforced by changes in non-wage compensation leading to a large increase in total compensation inequality. These wage structure changes translated into a rise in household income inequality. The trend to wage inequality in the 1990s was considerably slower than in the 1980s, with the key feature being that the highest earners (the 90th percentile of the wage and earnings distribution) continuing to grow faster than the median, but no noticeable decline for low earners. The more recent labor market data suggests a continuation of this pattern.[11]

Low-income features of the Tax Code. In 2007, the Treasury projects that the share of individual income taxes paid by low-income taxpayers will fall, while the share of taxes paid by high-income taxpayers will rise. At the same time, the share of taxes paid by the bottom 50 percent of taxpayers will fall from 3.8 percent to 3.4 percent. Since there has not been a dramatic change in the distribution of spending, this indicates that the impact is becoming more progressive. At the very highest levels of income, this is especially true, as the share of taxes paid by the top 5 percent of taxpayers is projected to rise from 55.3 percent to 56.5 percent.

As these figures indicate, a great many Americans pay no income tax at all. In 2007, a married couple with two children will have no tax liability until their income reaches $42,850. For those low-incomes families near the poverty level, refundable tax credits like the child tax credit and the earned income tax credit (EITC) provide payments from the Treasury to those families. A single parent with one child and $14,257 of income (i.e., the estimated 2007 poverty level for a two-person family) will receive $3,410 back from the Federal Government in 2007.

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[10] See, for example, Attanasio, Orazio and Steven J. Davis. 1996. "Relative Wage Movements and the Distribution of Consumption." Journal of Political Economy 104 (December): 1227–62;,Autor, David H., Lawrence F. Katz, and Melissa S. Kearney. 2005. "Trends in U.S. Wage Inequality: Re-assessing the Revisionists." NBER Working Paper 11627, September; Autor, David H., Frank Levy, and Richard J. Murnane. 2003. "The Skill Content of Recent Technological Change: An Empirical Investigation." Quarterly Journal of Economics 118 (November): 1279–1333; Cutler, David M. and Lawrence F. Katz. 1991. "Macroeconomic Performance and the Disadvantaged." Brookings Papers on Economic Activity, 1991:2, 1–74; Cutler, David M. and Lawrence F. Katz. 1992. "Rising Inequality? Changes in the Distribution of Income and Consumption in the 1980s." American Economic Review 82 (May): 546–51; Goos, Maarten and Alan Manning. 2003. "Lousy and Lovely Jobs: The Rising Polarization of Work in Britain." Unpublished paper, Center for Economic Performance, London School of Economics, September; Hamermesh, Daniel S. 1999. "Changing Inequality in Markets for Workplace Amenities."Quarterly Journal of Economics, 114(4), November, 1085–1123; Karoly, Lynn and Gary Burtless. 1995. "Demographic Change, Rising Earnings Inequality, and the Distribution of Well-Being, 1959–1989." Demography 32: 379–405; and Piketty, Thomas and Emmanuel Saez. 2003. "Income Inequality in the United States, 1913–1998." Quarterly Journal of Economics 118 (February), 1–39.

[11] Another set of concerns relates to inadequacies in the measurement of earnings, income, and standards of living more generally. For example, (1) real wages have grown more slowly than real compensation because benefits are a rising portion of total compensation; (2) standard price indexes overstate inflation, causing an understatement of real compensation gains; and (3) traditional poverty measures failure to adequately reflect redistributive taxes and transfers.

Taxation of carried interests. Recent discussions and legislative initiatives have raised the possibility of taxing so-called "carried interests" as ordinary income instead of capital gains. By itself, such a change would not improve the performance of the Tax Code. As noted earlier, a fundamental unfairness of the current Tax Code is that similar taxpayers are taxed differently. Under such a proposal, investments in real estate (for example) would face different effective tax rates depending upon whether they are undertaken by an individual, through a real estate investment trust, or via a limited partnership. This inequity would carry with it an efficiency cost as the higher tax would discriminate against a particular organizational form—the partnership—that was previously preferred by investors. Moreover, as noted above the benchmark for efficient, pro-growth tax policy allows a deduction from the tax base for all saving and investment, while taxing at a common rate all cash flows. The proposed tax change imposes the latter taxation, without the corresponding deduction. In short, it is a move in the wrong direction for the Tax Code.

In the absence of broad reform, there appears to be little merit to changing the tax treatment. As noted in a recent analysis by Michael Knoll, taxing the cash equivalent of the carried interest will raise modest amounts of revenue.[12] In reaching this conclusion, he computes the cash value of an option contract that mimics carried interest for general partners, and calculates the additional taxes that would be collected by taxing this cash grant as ordinary income. In his analysis, this represents the additional payments that limited partners would be required to offer in order to retain sufficient inducement to attract general partnership talent. Another perspective on this analysis, however, is to note that he employs a conventional formula for valuation that assumes independent freedom to exercise the option and deep, liquid markets for the underlying asset. In the context of some investments, these likely overstate the reality and thus the value of the option. At present, the Tax Code treats the grant of the carried interest as of low and hard to quantify value, assumes reinvestment of the grant, and taxes the result as a capital gain. While imperfect from the perspective of investment and growth, it is preferable to the proposed alternatives.

Taxation of publicly traded partnerships. A related initiative is a proposal to subject certain publicly-traded partnerships to the corporation income tax. As noted earlier, good tax policy imposes a single layer of tax and achieves investment neutrality by integrating the corporation and individual income taxes. Increasing the double-taxation of saving and investment is a step in the wrong direction. Doing so in a discriminatory, non-uniform fashion increases distortions and represents unsound tax policy.

Table 1
Tax Receipts 1996–2006

Year	Individual Income Taxes		Corporation Income Taxes		Social Insurance Taxes		Total Revenue	
	Billions	Growth	Billions	Growth	Billions	Growth	Billions	Growth
1996	656.4	11.2%	171.8	9.4%	509.4	5.1%	1,453.2	7.5%
1997	737.5	12.3%	182.3	6.1%	539.4	5.9%	1,579.4	8.7%
1998	828.6	12.4%	188.7	3.5%	571.8	6.0%	1,722.0	9.0%
1999	879.5	6.1%	184.7	−2.1%	611.8	7.0%	1,827.6	6.1%
2000	1,004.5	14.2%	207.3	12.2%	652.9	6.7%	2,025.5	10.8%
2001	994.3	−1.0%	151.1	−27.1%	694.0	6.3%	1,991.4	−1.7%
2002	858.3	−13.7%	148.0	−2.0%	700.8	1.0%	1,853.4	−6.9%
2003	793.7	−7.5%	131.8	−11.0%	713.0	1.7%	1,782.5	−3.8%
2004	809.0	1.9%	189.4	43.7%	733.4	2.9%	1,880.3	5.5%

[12] Michael Knoll, "The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income," University of Pennsylvania, August 2007.

Table 1
Tax Receipts 1996–2006

Year	Individual Income Taxes		Corporation Income Taxes		Social Insurance Taxes		Total Revenue	
	Billions	Growth	Billions	Growth	Billions	Growth	Billions	Growth
2005	927.2	14.6%	278.3	47.0%	794.1	8.3%	2,153.9	14.5%
2006	1,043.9	12.6%	353.9	27.2%	837.8	5.5%	2,407.3	11.8%

Chairman RANGEL. Thank you all for your splendid testimony. I hope that all of you would feel comfortable in submitting to the chair which areas of the existing Tax Code you would believe that we should focus on in order to make certain that at the end of the day with our so-called reform measure that more people will believe that we're doing the right thing.

It's abundantly clear that one of the main reasons why Jim McCrery and I are in accord on taxes is that there's just no justification for who got caught up in the AMT. But in order to restore the lost revenues, we have to look at the entire Code. Also to remember that we have to encourage investment, which means that the Code, for good or for bad, has been used not just to raise revenue, but to direct people's behavior. Some of those things have worked, some of them have not worked, and we're hoping that there are a lot of provisions in the Code that people forgot why they were put in that we can take out and raise some revenue.

Having said that, I'm going to yield to Mr. McCrery. But we will be following through and getting some of your ideas so that we can have more time to go through those things because one of the things that I am persuaded by is that we have a voluntary tax system because people believe that it's fair, or we want them to believe that it's fair, and we have to do that, and we've got a big job to do. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman. Before we proceed with questioning the witnesses, Mr. Chairman, a former colleague of ours on the Committee on Ways and Means, Jennifer Dunn, we learned yesterday has passed away. Many of us on this Committee today served with Jennifer Dunn and know that she was a very valuable and respected Member of this Committee. We will miss her, not only here in this Committee, but as a friend and colleague. So, Mr. Chairman, in recognition of this Committee's respect for Jennifer Dunn and in memory of her, I would ask for just a moment of silence for the Committee before we proceed.

Chairman RANGEL. The staff has sent condolences and flowers to the family of the deceased. She was quite a lady. She was a tough lady, a charming lady, and a great Member of this Committee, and she certainly will be missed, but not the great contribution she's made. We'll have a moment of silence in memory of her.

[Moment of silence.]

Chairman RANGEL. Thank you. Now we have a vote on the floor. What's the situation? I think it would be better if we take a short recess, go vote and come back and then yield to you. Thank you.

[Recess.]

Chairman RANGEL. I will ask Congressman Neal to assume the chair and then yield to Mr. McCrery.

Mr. NEAL [presiding]. Thank you, Mr. Chairman. The chair now would yield to Mr. McCrery for his line of questioning.

Mr. MCCRERY. Thank you, Mr. Chairman. Thank you, witnesses, for your excellent testimony. I just have a few questions. Dr. Furman, I guess I'll start with you, because your testimony was interesting but also somewhat confusing. In one instance, you said, or at least what I heard you say, was that even with all the tax cuts—I don't know if you said the bottom quintile, but you said lower income earners were worse off. If in fact that's what you said, I doubt that's what you meant in an absolute sense, but maybe you were speaking in a relative sense in terms of the gap between the lowest quintile and other wage earners. Would you clarify that?

Mr. FURMAN. Yes, sir. I was actually speaking in an absolute sense. If you look at economic models that attempt to estimate the benefits of tax cuts for the economy, they always make financing assumptions about how the tax cuts are paid for.

So, for example, Professor Greg Mankiw and Matthew Weinzierl have a model in which they try to study if you cut taxes, what would the benefit or harm to the economy be? To make that economic model work, they assume that the tax cuts are paid for because they cost money. They're paid for by, for example, cutting Medicare benefits, cutting Medicaid benefits, cutting Social Security or raising lump sum taxes. When you factor in the financing of the tax cut and the effect on households, 74 percent of households in my analysis, using the tax policies in the microsimulation model, are made worse off.

That's using exactly the same models that, for example, the Treasury Department has used to argue that tax cuts will on average benefit the economy. Even if on average it does, when you take into account the financing in the Treasury model itself, most people are made worse off in absolute terms.

Mr. MCCRERY. Okay. I better understand what you were saying now. While that may fit into your model, your model, like any other economist's model, is full of assumptions. In your model, you're assuming that Medicare or Social Security or some kind of benefit will be cut because of the tax cuts. But if we can just for the moment set aside those assumptions that haven't happened yet, and may not happen, if you just looked at the impact on the bottom line of the taxpayer, isn't it accurate to say that all taxpayers benefited in terms of money in their pocket from the Bush tax cuts, especially when combined with transfer payments like the earned income credit? That's essentially—it's scored even by CBO as a spending program in part. So, when you consider those spending programs like that in conjunction with the tax cuts, isn't it accurate to say that everybody got some tax relief or some relief in their pocketbook?

Mr. FURMAN. I think it's still not everybody, but it's substantially more than what I said, that relief differed quite a lot, was much, much larger for high-income people.

Mr. MCCRERY. No.

Mr. FURMAN. Than for low-income people. The key question is whether that is a sustainable increase in people's incomes or whether we're going to pay the bills and become much worse off for it as a result. That's what these economic models are trying to ascertain.

Mr. MCCRERY. Yeah. I don't have any quarrel with the model. I understand how you get there. But I think you understand that those are assumptions. We can alter those assumptions with different policy changes. For example, we could solve the Social Security problem in a way that maybe your model doesn't contemplate, that would reduce benefits and also wouldn't necessarily over the long term take more revenue. So, there are all kinds of changes we can make in policy to alter the assumptions in your model.

I just want to get this question out real quickly. Dr. Burman, you talked about taking the, or repealing or revising the AMT, and we ought to do it on a revenue-neutral basis. Implicit at least in your remarks, or at least I inferred from your remarks, that you would recommend letting the 2001–2003 tax cuts expire on schedule which to me brings up the question that we don't talk about enough in this Committee, which is at what percent of GDP would you stop in getting revenues from the American people? Isn't that a question that we should consider from an economic standpoint? If you let all the tax cuts expire, if you do the AMT repeal on a revenue-neutral basis, you're going to get up to somewhere close to 21 percent of GDP coming into the Federal Government in revenue.

Mr. BURMAN. As Dr. Holtz-Eakin pointed out in his testimony, the real issue is spending. If you look at the projections going forward, starting in 2010 when the baby boomers retire, the Federal Government's spending is set to explode. You need to figure out how to rein in the growth of entitlements. I think it's unlikely that you'd be able to rein them in so much that you wouldn't require additional revenues.

So, my view is that undermining an important revenue source before you figure out how to control the growth in spending would be problematic. It would mean that you'd be pushing a lot of burdens on our children and on our grandchildren.

Mr. MCCRERY. Well, I'm certainly a proponent

Mr. BURMAN. Nobody likes taxes.

Mr. MCCRERY. I'm certainly a proponent of solving the entitlement problem in this country from a spending standpoint. I don't think they're sustainable as they're currently structured. But I guess I'd just like for you, maybe all three of you, to just give us a ballpark figure of where you think if we started getting 25 percent of GDP in revenues, would that be damaging to the economy in a fundamental way, or would it be 30 percent, or do you care?

Mr. BURMAN. Well, in part it depends on how you raise the revenues. The current tax system is very distortionary. There are lots of loopholes and deductions. The basis is fairly narrow and the rates are higher than they would have to be if there weren't a broader tax base. The ideal thing would be if we could broaden the base and keep marginal tax rates relatively modest going forward like we did in 1986.

As far as what the right level of revenue is, we need as much revenue as the government is spending over the long run. We

should try to raise it in a way that's both fair and progressive but also does as little damage to economic growth as possible. If you look at the projections going forward, the spending on entitlement programs, according to CBO, is going to be as large as total current Federal spending, and you're still going to need defense. You're going to need courts. You're going to need to pay for Congress. So, the right level of revenue really depends on what you can do to spending.

Mr. MCCRERY. If the other two witnesses would just comment briefly on my question.

Mr. FURMAN. Sure. I agree first of all it depends on how you raise the revenue. But second of all, a key question is timing. What we've seen in the last 6 years is actually not really a tax cut so much as a shift in taxes. So, if you raise taxes by a small amount today, that forestalls the need for much larger tax increases in the future, which is why I'd rather see us act sooner than later, and then we can have a lower level of revenue as a share of GDP that is consistent with funding the government that we want.

Mr. MCCRERY. Dr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. Well, I won't reprise my concerns over the spending side. If you spend it, ultimately you're going to pay for it. You're going to borrow the money now and raises taxes later or something of that nature. So, you've got to do the spending.

The second two guidelines you can look at are either history. We've not typically gone above 18 percent of GDP, and there's a reason for that. We can't deploy the highly inefficient Tax Code we have without having people rebel at above that level. Or we can look at other countries where, at least on the business side, we are now looking like a tax unfriendly jurisdiction, and we can't allow that to happen.

So, you know, we don't live in a vacuum. We've got to be cognizant of our international competitors, and we have to be cognizant of the fact that the private sector feels the burden of these taxes and responds.

So, I would be hesitant to push much higher.

Mr. MCCRERY. Thank you, Mr. Chairman.

Mr. NEAL. Thank the gentleman. The gentleman from Michigan, Mr. Levin, will inquire.

Mr. LEVIN OF MICHIGAN. Thank you very much. You know, when three economists testify I think the assumption is that your being economists, it's all going to be very complex and hard to understand I think for us here and for everybody else. But I must say from your testimony, certain key facts, key developments just spring forth.

Dr. Burman, you say income inequality has been rising since the mid-eighties and now approaches levels not seen since the Great Depression. That's a dramatic statement unchallenged so far. Then Dr. Furman, you say this, because one of the arguments in favor of inequality is that it spurs growth. You essentially challenge that this inequality has been a major generator of economic growth. You quote, you cite the Treasury Department analysis saying—having the projection of very modest economic gain from the tax cuts made permanent 0.04. That's less than one—that's four one-hundredths, right, of 1 percent?

Mr. FURMAN. Right.

Mr. LEVIN OF MICHIGAN. As you can imagine, Dr. Holtz-Eakin, we probably did look—we were going to look at your comments when you were with us. Going back to them, one of your comments regarding the President's tax policies, and I quote, "taken together, the proposals would provide a relatively small impetus in an economy the size of the United States." So you have the tax cuts, including those regarding capital gains and dividends and the savings rate in this country has remained essentially stagnant.

So if the motto is growth with equity, to put it rather plainly, and I'd like all three of you to comment, there's been almost historically high growth in inequality. It has not sparked basically economic growth. So we've gotten the worst of both worlds. So, comment on that. Dr. Holtz-Eakin, your testimony seems to talk about other things and a consumption tax and we can talk about that. But what is the thrust of the testimony of Dr. Burman and Dr. Furman is that it's been a bad deal for this country in terms of this nearly historic inequality that has not been a major spark of economic growth.

So, why don't we go down the row and leave time for each of you, if you would.

Mr. BURMAN. Thank you, Mr. Levin. It's certainly true that at the same time that economic inequality has risen dramatically, the economy has actually grown pretty well over the last two decades, but it's not clear that there's any link between the two.

I would also say that as Dr. Holtz-Eakin has pointed out, that it's not tax policy that has caused the pre-tax inequality per se, although it can mitigate it somewhat. I think any economist would say that there is a link between tax policy and the economy, but there are ways you could actually make the tax system more progressive without entailing additional costs on the economy. You could probably make it more progressive and actually make the economy grow better.

Mr. LEVIN OF MICHIGAN. Dr. Furman

Mr. FURMAN. One of the numbers in my written testimony was that there was a $664 billion shift in income from the bottom 80 percent to the top 1 percent——

Mr. LEVIN OF MICHIGAN. Dramatic.

Mr. FURMAN [continuing]. Over the last 25 years, 664 billion. When you think of something like international trade, some people have estimated $500 billion to a trillion dollars of benefits from international trade. When you look at numbers like that, the benefits of trade, the magnitude of inequality, it says that the types of policy responses that we should have to deal with inequality, to deal with trade and globalization should really be at the scale of those problems and those issues. We've been going in the wrong direction for the last 6 years. We really should be going in the right direction and quite substantially.

Mr. LEVIN OF MICHIGAN. Dr. Holtz-Eakin, you have the last word.

Mr. HOLTZ-EAKIN. Yeah. I think Dr. Burman said it pretty clearly, which is that we have seen rising inequality in wage earnings in the eighties, dramatically at the top and bottom in the nine-

ties, much more dramatic at the top than at the bottom, and those trends appear to continue today. They're not driven by tax policy. This is not a tax policy issue. The dividing line between those who get high earnings and those who do not are driven by education, and that if you want to go find out how to improve those outcomes, you would begin by having kids arriving at school ready to learn and you would improve the performance of the whole school system. That's it.

Mr. LEVIN OF MICHIGAN. I agree. You're saying tax policy has been irrelevant to the growing income inequality?

Mr. HOLTZ-EAKIN. I think it has had very little to do with the labor market earnings inequality that the professor's document that I referenced in my testimony. So, you're looking at the wrong culprit if you're looking at tax policy and labor market outcomes.

Mr. LEVIN OF MICHIGAN. Dr. Furman.

Mr. FURMAN. One thing I looked at again in my written testimony is if the Tax Code had stayed as progressive as it was in the year 2000, the progressive tax system would have offset 20 percent of the increase in inequality I talked about. Of that 664 billion, 20 percent of that would have been offset by the progressive Tax Code. But as a result of tax changes from 2001 to the present, the Tax Code ended up offsetting a much smaller portion of that increase in inequality, less than a third as much as it would have otherwise.

So, I agree with Dr. Holtz-Eakin. I don't think taxes are the cause of inequality. But the tax system, even if you had just left it in place, would have solved about one-fifth of the problem. Instead, we tampered with it, and it solved less than 10 percent of the problem.

Mr. LEVIN OF MICHIGAN. Okay. Thank you.

Mr. NEAL. I thank the gentleman. The gentleman from California, Mr. Herger, will inquire.

Mr. HERGER. Thank you, Mr. Chairman. A question for Dr. Holtz-Eakin. We've heard many in the majority complain that President Bush and the tax relief of the last several years increased the number of taxpayers on the alternative minimum tax or AMT. I think we can all agree that negative effects of the AMT on the unsuspecting middle class Americans and about the need to eliminate this tax regime that was never intended to dip into the middle class. But my question to you is if a taxpayer did become subject to the AMT because President Bush's tax cuts lowered their regular tax liability, would they still receive an overall tax cut? In other words, whether or not they paid regular income tax or AMT, am I correct in saying that the Bush tax cuts would not increase the total income taxes of any taxpayer?

Mr. HOLTZ-EAKIN. That's correct. So, he gave them a tax cut. There's no question about it.

The tables at the beginning show this. I mean, they say what fraction of the people's tax cuts got taken by the AMT? None of those fractions were over 100 percent. No one's taxes went up. They went down.

Mr. HERGER. So, this allegation and implication that somehow the Bush tax reductions in which we've seen the results of a major increase in our economy, major increase in revenues, total revenues to the Federal Government, despite the fact that taxes went down,

the fact that somehow these in the lower income tax bracket are paying more is just absolutely incorrect. Is that true?

Mr. HOLTZ-EAKIN. It's incorrect. People are paying less in total taxes, and there's no question if you look at the problem with the AMT, the problem is not the cuts in the regular income tax. The problem is the AMT is not a very good tax. It's not indexed for inflation and it should have been a long time ago. It doesn't make any sense from the point of view of a tax base. It doesn't, you know, sort of recognize family size. It's got very high marginal rates. This is not a tax anyone should embrace. It's a bad tax. The real indictment is that we need it at all. The fact that we have an AMT says that our regular tax system makes no sense, so we're going to patch it on the side with this alternative. Fix the Tax Code. Stop staring at the AMT.

Mr. HERGER. Thank you. That's very helpful and incredibly important for trying to clarify this debate. You say in your testimony that recent evidence suggests the relatively high U.S. corporate income tax is ultimately paid by workers in the form of lower wages. Can you please speculate for us the effects on raising taxes on small businesses?

Mr. HOLTZ-EAKIN. Well, there are two dimensions to that. I mean, the first is economists have struggled for a long time to try to pin who actually is harmed when we tax a particular type of business activity, in this case the C corporations, the Chapter C corporations.

You know, corporations aren't going to pay that tax. They're either going to charge their customers higher prices, cut payments to shareholders and cut back on investment, reduce wages. It's going to go somewhere. Some of the recent evidence suggests that given the global mobility of capital, that what is really going to happen when that tax goes up is the capital won't tolerate a lower return, so the workers are going to pay it. So that tax is harmful on workers in the global context.

The second piece of evidence is largely domestic, and in research I've done with multiple co-authors, the kinds of people who are in sole proprietorships, small businesses of different legal forms, appear to be unusually sensitive to taxes and tax increases cause them to invest less in the firms, cause them to grow their payrolls slower. They don't hire people. They don't give them raises. They tend to go out of business more quickly, if you have higher taxes.

Mr. HERGER. Doctor, I thank you very much. Again, this just brings out the importance of the debate. The debate between the party that's in the majority that somehow feels we're not paying enough taxes, that taxes need to be increased, and the part I belong to, the minority party right now that feels that just the opposite is true. We need to be moving toward lowering our basic taxes, and the results are clear.

Despite what conventional wisdom might predict, when we lower taxes at a time when taxes are high, revenues actually increase, and the opposite happens when we raise taxes. Revenues actually decrease, and we see the economy hurt. More importantly, we see our citizens hurt. So, I want to thank you very much for your testimony and for your being here testifying before our Committee today.

Thank you, Mr. Chairman.

Mr. NEAL. Thank the gentleman. The gentleman from Washington, Mr. McDermott, is recognized to inquire.

Mr. MCDERMOTT. Thank you, Mr. Chairman. This is a country that fundamentally believes in hard work, and you could call it the Protestant work ethic or whatever you want to call it, but the value of work has really been the bedrock of our society. Today it looks like we're headed back, it seems to me, toward the Gilded Age when hard work didn't mean very much. We're the most productive workers in the world at this point, even beating the Norwegians, but we're returning to an age really when the nation's spoils seem to go to the few while the rest of the folks work.

Now Mr. Burman's testimony is replete with data that bears out these facts. Income inequality is approaching levels not seen since the New Deal. Low- and middle-income families are working longer, harder, more efficiently, but their real wages are flat and they're falling in the face of rising energy, housing and health care costs.

Since the year 2000, the cost of employment-based health premiums has gone up 87 percent. Now American families today are walking a tightrope over a snakepit really of economic insecurity. The social safety net has been ripped, but the corporate America seems to enjoy a real lifeline of tax holidays. There just seems to be a lack of fairness in the policies.

I put up this slide on the screen for people to look at. No one disagrees with this. This is the Urban Institute, Brookings. This is—everybody realizes that all the money is going to the people on the far right end. The tax laws implemented over the last 6 years have exacerbated the challenges that globalization imposes on working families. Aftertax income inequality is dramatically more severe because of the tax cuts that have been put in place. It's obvious from looking at it, and Mr. Furman's testimony really bears that out.

Now as low- and middle-income families lose their health care, their pensions and their homes, the affluent are bathed in these tax cuts which were about to expire. Now the AMT nails middle-income again and volunteers fight an endless war in Iraq. The fortress of Wall Street really goes on almost untouched by this, and wants to protect a tax rate of half the rate that the ordinary people in this country are paying.

It seems to me that our real issue here is that we need to design a tax policy and labor policy that responds to globalization. This is a new era. This is not the Industrial Age. This is the Globalized Age. I'd like, Mr. Furman, for you to talk a little bit about as these tax cuts expire—the Republicans set it up for them to expire in 2010, and I don't think we should, as they say, get in the way of a man when he's doing himself in. They did it. They set it up. We should let them expire. Then let's talk today about what we should do with things like unemployment insurance reform or universal health care or wage insurance or continuing education. I'd like to hear how you would spend the money which is going to come to us as a result of the expiring tax cuts. Or maybe just get rid of the AMT. I mean, that may be one thing. But there's some other things, it seems to me——

Mr. FURMAN. Right.

Mr. MCDERMOTT [continuing]. That we have to do to make equality in this society.

Mr. FURMAN. Right. Thank you for asking me that question, and I run something called the Hamilton Project at the Brookings Institution, and we have put out policy proposals on every one of the issues you just mentioned, including wage insurance, health insurance and unemployment insurance. Of those areas, I think achieving universal health insurance is far and away the most important goal.

You look at the tax cuts, they cost $200 billion a year. You could do a feasible plan for universal health insurance that costs maybe $100 billion a year, for half of the cost of what we did for the tax cuts, if you're willing to consider altering the tax exclusion for health insurance as the administration did, you might even be able to do a plan that gets health insurance for everyone at no additional cost.

Mr. MCDERMOTT. Are you talking about a universal national health plan, or are you talking some kind of band-aid system on the present employer-based system? What are you talking about?

Mr. FURMAN. The $100 billion number would be for something that builds on the existing system and fills in the cracks, providing options for people who don't have options within the system. If you switch to a national health insurance system, some form of single payer, the additional cost to the government would be more than $100 billion, although then you would have an additional savings to individuals of, you know, five or six hundred billion dollars a year of the premiums that they're paying for their health insurance right now.

Mr. MCDERMOTT. So, the money——

Mr. FURMAN. But I was talking about a more incremental system. It would still cover virtually every single one of the uninsured.

Mr. MCDERMOTT. The bottom line is, there is the money to do universal health care coverage for all Americans inside this present system if we do it efficiently?

Mr. FURMAN. The bottom line is that there are tradeoffs that have to be made, and if you do more in one area, you can do less in the other area. So, if you do tax cuts like that, you won't be able to afford to do universal health insurance.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

Mr. NEAL. I thank the gentleman. The gentleman from Michigan, Mr. Camp, is recognized to inquire.

Mr. CAMP. Well, thank you, Mr. Chairman. Dr. Holtz-Eakin, there's been a suggestion that income equality is rising, and using the data they use has a certain definition of income. But other experts define income in a different way and leave out significant amounts of cash and noncash income the households have.

Can you comment on what gets counted as income for purposes of some of these studies and discussions?

Mr. HOLTZ-EAKIN. I'll comment briefly. It's a topic that's enormous, quite frankly. But——

Mr. CAMP. It is enormous. I would agree with that.

Mr. HOLTZ-EAKIN. The key thing for the Members to know is that there is absolutely a consensus that inequality in labor market earnings has increased over the past two-and-a-half decades, and

there's a list of potential explanations. Much of them revolve around education, skills and abilities, period.

Mr. CAMP. But, for example, does the definition of income include the value of the earned income tax credit?

Mr. HOLTZ-EAKIN. So, the point I wanted to make is that's a very narrow slice of how people actually live. You want to get to, you know, how do people live at the end.

Mr. CAMP. What do they actually have in real life? What resources do they have in real life?

Mr. HOLTZ-EAKIN. Earnings. Then compensation including, you know, non-wage compensation, health insurance, things like that. Then you want to take that and add taxes net of transfers, or add transfers——

Mr. CAMP. Taxes they pay and other——

Mr. HOLTZ-EAKIN. The poverty statistics leave those out. Then you want to deflate them for the cost of living, and we have, you know, higher quality goods cheap. Then you get to a standard of living.

Mr. CAMP. The Census Bureau figures don't do any of that, do they?

Mr. HOLTZ-EAKIN. No.

Mr. CAMP. So, the Census Bureau doesn't include food stamps or housing assistance?

Mr. HOLTZ-EAKIN. No.

Mr. CAMP. Medicaid spending. I think one of the difficulties this Committee has had is coming up with a uniform definition of poverty, because then these figures can be used to say whatever they want. I would just agree with you that this is an immensely complicated topic. I would ask unanimous consent to include in the record a report by the Heritage Foundation that expands on these and other definitions and deficiencies in the way income is calculated and would submit that for the record.

But I also want to comment on some of these Census Bureau numbers that get put out there. For example, they often divide the population up into fifths. Those don't have equal numbers of people in them, do they? So, the top fifth has more people than the bottom fifth.

Mr. HOLTZ-EAKIN. Depending on who does them, quite frankly. That's why it's hard to compare them.

Mr. CAMP. I'm talking Census Bureau.

Mr. HOLTZ-EAKIN. In the census poverty numbers?

Mr. CAMP. Yes.

Mr. HOLTZ-EAKIN. The census poverty numbers, the income distribution is over households, and you have to figure out household sizes and things like that.

Mr. CAMP. Yeah. The quintiles are not equal in terms of numbers of people.

Mr. HOLTZ-EAKIN. Right.

Mr. CAMP. So you obviously are not making—obviously the comparisons, then, are not between comparable numbers of households in these various categories, and then results in a skewed percentage. So, I think that, without getting too far into the weeds on that, I think that it's important just to state that census figures ignore taxes paid and most of the social safety net that is available to the

American people both in terms of Federal and state dollars. Is that an accurate statement?

Mr. HOLTZ-EAKIN. Yes. The census figures are highly incomplete. I would highlight a second problem with them, which is that they're not counting the same people every year. The mobility of individuals across different standards of living is a key part of what goes on in the U.S. economy. The evidence doesn't suggest there's been a dramatic change in economy mobility. So, you know, the idea that somehow things are very different than they were 20 or 30 years ago is not supported by the data. We do have issues in giving people labor market skills, both in advance and after their job prospects change, that are real and genuine. But they're not addressed by those statistics at all.

Mr. CAMP. Just in closing, I would agree. So, this leaves us with a definition of income that's incomplete and ignores really the efforts that are made in terms of the social safety net and the dynamics of our society where people are mobile and move from one income category to another over time, which would really—which really prevents us from getting a clear picture of what the situation in America is.

So thank you for those comments, and I yield back the balance of my time.

Mr. NEAL. The chair would recognize the gentleman from Georgia, Mr. Lewis, for inquiry.

Mr. LEWIS OF GEORGIA. Thank you very much Mr. Chairman. Mr. Chairman, let me thank the witnesses for being here. Since we have these three distinguished economists here, I'd just like to ask a very general question, and maybe I can come back to something in particular. We have this unbelievable involvement abroad in a war in Iraq and Afghanistan. The only people that have been called upon to sacrifice are young men and our young women in uniform.

I'd like to hear your opinion about is there some way to use the Tax Code to get other Americans to sacrifice, to pay something for our involvement in these two military conflicts? Is it fair? Is it right? Is this just?

Mr. BURMAN. I'll certainly comment on the fact that as far as I know, it's unprecedented that we've launched a major war and at the same time enacted huge tax cuts. The mentality of the country is a lot different than it has been in the past. Bill Gates, Sr. and Chuck Collins in their history of the estate tax, explained it during World War I, as a "conscription of wealth," and by ones to the conscription of young men to serve in the military. Basically, it was a way of drawing on the people who were most wealthy to help support the effort as well so they could also share in the sacrifice.

It's kind of ironic that at the same time that we have this war going, we've actually proposed to eliminate the estate tax, which is supposed to disappear in 2010.

Mr. FURMAN. I guess I would agree with Dr. Burman. The last time I was before this Committee, CBO Director Peter Orszag read a letter that his staff had prepared him, and it was to the effect that there has not been a single other case, with the exception of one technical incident during the Mexican War in 1837 I believe, in which taxes were cut in a time of war. That's very unusual.

It's especially unusual because it's not just a time of war. It's a time where we understand we're going to have for homeland security and for national security higher expenses going forward for a very long time. Even if we weren't in Iraq, even if we weren't in Afghanistan, just our homeland security needs are higher than what they were in the year 2000. In response to that, you normally don't try to cut taxes, borrow the money, and have to raises taxes substantially in the future as a result.

Mr. HOLTZ-EAKIN. I think it's first important to note that there is no tax or budgetary sacrifice that's going to compare with the service of the young men and women in the armed forces. Let's be honest about that. That means that we should be honest about everything. That means we should, and I echo the comments of Mr. Furman, put on the books the real costs of fighting a war against a group of extremists who wake up each day trying to destroy this way of life, and it's going to be a long battle. Every dollar of expected spending in Iraq, Afghanistan and the rest of the fronts should be budgeted, and budgeted all the time. To pretend otherwise is bad government fiscal policy.

At that point, the tradeoffs will have to be clear. As you know, I believe we have overspent the Federal budget many times going forward, so simply adding more spending is not something this Committee has the luxury of doing. There will have to be some cutbacks in spending and a tax policy that will not cripple the economy put in place.

Mr. LEWIS OF GEORGIA. Thank you very much. Dr. Furman, you have suggested that the tax treatment of retirement saving provide a windfall for Americans who already have enough money and are already inclined to save, while offering few options for low- and moderate-income Americans to save for their future.

As you look at the years since the enactment of the 2001 and 2003 tax cut and the performance of the economy, what changes do you recommend that we make to ensure that all taxpayers have enough money left over at the end of the day to put into savings?

Mr. FURMAN. Mm-hmm. Let me recommend both a paper by the Hamilton Project written by Bill Gale, Peter Orszag and John Gruber, and also the work of the Retirement Security Project at Brookings. A minimal step would be taking things like the saver's credit, which were enacted, making them refundable and more transparent so that low- and moderate-income families could truly benefit from them in their savings.

A set of more ambitious steps would make savings easier, more automatic, help people turn their savings into an annuity when they retire, so that they can have a stable income in their retirement and have more generous tax credits for low- and moderate-income families to help them save. So, there's a lot of steps both within the Tax Code and within pension reform you could take that I believe would be economically beneficial in terms of increasing national savings, and also beneficial in terms of increasing the retirement security of working families.

Mr. LEWIS OF GEORGIA. Thank you very much. Thank you, Mr. Chairman.

Mr. NEAL. We thank the gentleman. The gentleman from Pennsylvania, Mr. English, will inquire.

Mr. ENGLISH. Thank you, Mr. Chairman. Mr. Chairman, this testimony has been stimulating and certainly there have been a lot of surprises. For example, in Mr. Burman's testimony a couple of minutes ago to the effect that we've never financed a war while cutting taxes. My impression was that we had financed the Cold war during the eighties by cutting taxes, but that's I suppose maybe just my ideological perspective on things.

Dr. Burman, I was also surprised by my good friend Mr. Neal's statement that the impact of the AMT was having a surprise impact on the Bush tax cuts. Wasn't the existence of the AMT pretty well known at the time, and weren't the estimates prepared by the Joint Tax Committee done with full anticipation that some taxpayers, depending on their circumstances, might be subject to the AMT?

Isn't it true that taxpayers are receiving the full benefits of more than $1 trillion in tax cuts as estimated by the Joint Committee on Taxation? Maybe more importantly, isn't the suggestion that the Bush tax cuts have tossed people into the AMT a little misleading? Would you agree that while more people might be paying the AMT because of the interactions with the 2001 and 2003 tax cuts, there's not a single taxpayer who is paying more in taxes than they would if these bills had not been enacted?

Mr. BURMAN. It's basically true. It turns out there are a few married people filing separate returns that actually might pay a little bit more, but almost nobody pays more taxes because of the interaction of the AMT and the 2001–2003 tax cuts.

Mr. ENGLISH. Outstanding. That's extremely helpful. Now the point you were——

[Laughter.]

Mr. ENGLISH. I'm sorry, Mr. Chairman. Do I have the floor here? You also made an interesting point about your concern about undermining the revenue source. This was in response to Mr. McCrery that the tax cuts might be undermining a revenue source that is essential to deal with long-term entitlement challenges. I think that's an interesting argument. I think you also conceded that perhaps spending is a big part of the key here.

Now Dr. McDermott laid out his programmatic menu of things that could be invested. Would it not undermine the revenue source equally in dealing with long-term entitlement needs to encumber those moneys with new entitlements?

Mr. BURMAN. I certainly think that would be a problem. Somehow you need to get the entitlements under control. I think there are probably ways that—actually, I'm sure there are ways—you could expand health insurance coverage without increasing overall spending. Dr. Holtz-Eakin, discussed the problems facing small businesses. I think one of the big problems facing small businesses right now is the way health care is financed. Actually, if some of the costs could be taken off the backs of small businesses, they would actually be able to compete more effectively with foreigners.

Mr. ENGLISH. That's an excellent point. Dr. Burman, on a separate point, and I was delighted to see that the deduction for state and local taxes has been brought up. As the Joint Tax Committee has shown, the inability to deduct state and local taxes for AMT

purposes is one of the primary preference items that causes individual taxpayers to become subject to the AMT.

Some might argue that this is unfair, since those who have already paid the state taxes might be less able to pay Federal taxes. But isn't it also correct that the deduction for state and local taxes acts as an implicit subsidy by low-tax states of those living in high-tax states? Isn't it also true that residents of many of these low-tax states are on balance relatively less prosperous than those in high-tax states? If so, isn't there an equity concern when those who are better off are asking those who are worse off to help offset the cost of more extensive state and local government services that after all is their option?

Mr. BURMAN. I agree with that. State and local tax deductions are actually very regressive. The largest benefits go to very high-income people, people who are above the AMT threshold, and it benefits the states with the largest tax bases. If you're actually going to try to provide assistance to the states, it would make a lot more sense to target it to the states that need help, places like Arkansas, Louisiana, where they get very, very little.

Mr. ENGLISH. Dr. Furman in his testimony made the point that income inequality in America has increased nearly continuously since 1979. Dr. Holtz-Eakin, can you identify any time in history when a period of economic growth did not lead to an increase in income inequality?

Mr. HOLTZ-EAKIN. I'm smart enough to know that I'm sure that you could slice some time period to find one where that isn't true, but by and large, markets reward—market rewards are different. To get growth, you have to have market rewards, and so you get differences in outcomes for the people who follow the market and those who don't. Inequality is part and parcel of a market economic system.

Mr. ENGLISH. I have many more questions, but I'm out of time. Thank you, Mr. Chairman, for your indulgence.

Mr. NEAL. We thank the gentleman. Mr. Burman, we've had some questions about how much of the Bush tax cuts some taxpayers lose to the AMT, with some losing as much as two-thirds.

I want to ask you about a chart in your testimony, Table 1 on page 4. It shows that some taxpayers at the highest incomes receive an average tax cut of $230,000. Do these taxpayers lose any of their tax cuts to AMT?

Mr. BURMAN. Sure. They lose a little bit, but if you look at Table 3 of my testimony, the people with the highest incomes actually lose the smallest share among people with incomes over $50,000. The percent of the tax cut taken back for people earning over $1 million, basically that income group in the first table, is less than 5 percent. Families with incomes between $100,000 and $200,000 lose more than a third.

Mr. NEAL. Mr. Furman, is that your position as well?

Mr. FURMAN. I am less of an expert on the AMT than Dr. Burman is. In fact, everyone in the country is less of an expert on the AMT than Dr. Burman is, but I believe that's correct.

Mr. NEAL. Thank you. Mr. Eakin.

Mr. HOLTZ-EAKIN. Mr. Furman was talking while you were giving your question so I didn't actually get to hear you. I apologize.

Mr. NEAL. That's part of our strategy.

Mr. HOLTZ-EAKIN. I see. I will stipulate, however, that Len Burman knows more about the AMT than I do.

Mr. NEAL. Sometime ago as a Member of the Budget Committee as a designee from the Committee on Ways and Means, I had a chance to question you in your role, your former role. Is it still your position that the Bush tax cuts did not pay for themselves?

Mr. HOLTZ-EAKIN. I don't think tax cuts pay for themselves, and I don't think sensible economic evidence supports that position. Good tax policy matters, but it's not somehow a genie out of which you can pull money to spend. That's not the way it works.

Mr. NEAL. Thank you. I was driving along in the car, as I referenced earlier, a few months back, and I heard you repeat that in an interview you were doing with Carey Gross on Public Radio, and I thought the fact that you were willing to restate that position first in testimony before the Budget Committee, with the Public Radio show and today, it's very gratifying to all of us.

Since I haven't used all of my time, I'd like to go to Mr. Tanner for inquiry.

Mr. TANNER. Thank you very much, Mr. Chairman, and thank all of you for being here. I don't know of any reasonably sane person who thinks this country is on a long-term, sustainable financial path. A lot of reasons for that, but I don't know anyone who would argue that we can keep doing the same thing we've been doing for the last 6 years and be an economically viable entity known as the United States of America.

As you know, I have been talking about this accumulation of debt, and we have been arguing vociferously for PAYGO rules that mean something, and we've been trying to talk about the debt accumulation that has taken place in the last 60, 70 months as part of a larger problem.

Balancing the budget is a good idea, but in and of itself, I don't think it's all that important. But the consequences of what we have done over the last 6 years with this new debt have resulted in an erosion of the tax base of about $85 billion a year. In other words, had we not embarked on this economic game plan that induced all this new borrowing, we would have on the same tax base about $85 billion to fix some of these problems like AMT, health care, education and so forth.

What's even more disturbing to me is the fact that 75 percent of this new debt, 1.6 trillion in the last 60 months, has been financed by foreign interests. Now I've talked to Dr. Holtz-Eakin about this before. I personally believe that countries like China are engaged in a long-term strategy to gain financial leverage on this country for a larger geopolitical reason, and I think I have some pretty good evidence to point that out. When we try to talk to them now about the currency or we try to talk to them about something else, they're not there yet, but eventually if we keep going down this same road, they'll be able to say United States, you better stay out of this or we'll roll Wall Street. We have the ability to do it.

But all of that aside, what we're here today to talk about is trying to fix AMT specifically but the larger economic problem. Almost every economist I've talked to agrees that there is no way to cut spending out of domestic discretionary spending to fill this gap. It's impossible. There's just not enough money. You could virtually abolish the Federal Government here in Washington as we know it, and you still can't make ends meet if we continue down this path.

Given that, if you accept that as a fact, and if you accept the fact that there's not currently the political will in this country to do something about entitlement reform, we have a short-term problem that has got to be fixed, because every year we borrow another 100, 200, 300 billion dollars, whatever it is, we erode the tax base the next year to the extent that we start paying interest on whatever we borrowed this year.

Could I get your collective opinions as to what we can do? I personally, when it comes to AMT, the short-term fix every year is just money down the drain and it's not a rational tax policy to fix a particular problem. I could go on, but I'll stop there and ask—I see the yellow light come on—for your comments on my ramblings. Thank you.

Mr. BURMAN. On the issue of AMT, the best thing would be to clean up the tax system overall, and as part of that you could come up with enough revenues to pay for financing the AMT. You could repeal the state and local tax deduction. That would raise more than enough money to do it. Those are difficult things to do, obviously.

I put together an option sort of illustrate another alternative that would pay for repealing the AMT and retarget it on people who were its original intended targets, and that's a surtax on adjusted gross income over $200,000 for couples and $100,000 for singles, at a 4-percent rate. Now this isn't ideal tax policy, but it would be a lot simpler than the current AMT. People would understand it. It would actually raises taxes on millionaires, who were the original targets, and cut the on most other people, and it would be revenue neutral. It wouldn't add to the deficit over time.

Mr. FURMAN. I would suggest—oh, should I answer the question?

Mr. TANNER. Please. Answer it, yes.

Mr. FURMAN. Okay. Just very briefly, I would suggest two steps. One is to do no harm, and that would be the PAYGO rules. If you do that, I think you could avoid any immediate fiscal problems that we might otherwise face. So, for example, the way this Committee has handled S–CHIP by paying for the proposal and showing that you can expand children's health insurance without expanding the budget deficit.

In the long run, PAYGO, though, isn't going to solve our problem. It's not going to get us out of the hole. It just means we won't dig any deeper. I think both the spending side and the revenue side are going to need to play a role into bring us into long-run fiscal balance, with a lot of the emphasis on health care, Medicare and a systemwide health reform.

Mr. HOLTZ-EAKIN. I think you've got the diagnosis exactly right. This isn't a discretionary spending problem. It's the manda-

tory programs. The good news is, those are in your jurisdiction in this Committee. The bad news is those are in your jurisdiction in this Committee.

My concern with the advice you're getting is that if the short-term fix is to raise taxes, however, that will always be the short-term fix. You will never come to grips with the entitlement programs. You cannot in any economically sensible way tax your way out of this problem. So if you repeat the short-term fix, you will have set course toward a cliff. I would encourage you to not do that. It is not something that can succeed in the long run.

Mr. NEAL. Thank you. The gentleman from Missouri, Mr. Hulshof, is invited to inquire.

Mr. HULSHOF. Thank you, Mr. Chairman. I was an economics major in college, did not do well in geography, and I'm not sure, maybe someone here knows, what point on planet Earth is exactly the opposite of Washington, D.C.? But I'm convinced after listening to some of my colleagues that we are that far apart on economics. That there are some of us here in Washington and there are some others on the other side of planet Earth as far as what to do about this economy.

I appreciate my friend, and he is my friend, from Massachusetts, referencing the history, Chairman Mills, creation of the AMT. I lament the fact that in 1999 the President of the United States had the opportunity to completely and finally eliminate the alternative minimum tax and yet vetoed that bill. I wish we had had a bipartisan solution back then.

Let me pick some of the points that you all have made in the time that I have. Dr. Holtz-Eakin, it's great to have you back. You indicated that tax policy has little impact on income inequality. I think you had been asked that, and you would acknowledge that again for the record, would you not?

Mr. HOLTZ-EAKIN. Yes. It's not the source of income inequality.

Mr. HULSHOF. Can tax policy have an impact on the growth or the contraction of our National economy?

Mr. HOLTZ-EAKIN. Absolutely.

Mr. HULSHOF. Could you give an example or two?

Mr. HOLTZ-EAKIN. Well, there's lots of economic research that suggests taxes that target consumption and not income will augment long-run savings investment and economic growth. The numbers never appear very dramatic, a couple of tenths of a percentage point growth rate per year. But remember, a couple of tenths of a percent per year is the difference between the United States and England. By doing that over a long period, we rose from being not much in the way of an economic power to the largest economy on the globe, and England went from the largest power on the planet to something that is far less impressive. That growth matters.

Mr. HULSHOF. Would, for instance, the reduction of the cost of capital or savings and investment; i.e., dividends, capital gains, would that in your view at least have a positive economic benefit to certain sectors of the national economy?

Mr. HOLTZ-EAKIN. I would encourage the Members to read the written testimony, which goes on at length about how you can construct a tax system that has no tax on that return to capital, never-

theless meets the standards of fairness, simplicity and clarity that I think the American people demand.

Mr. HULSHOF. This is of course a simplified point of view, but my good friend from the state of Washington said, you know standing on the side to, as we do ourselves in, because of the tax cuts of 2003, and I would remind my friend that the economy was shedding 92,000 jobs per month in the 29 months before the '03 tax cuts on capital gains and dividends. Since then, the increase in net new jobs average about 167,000 per month.

Now it's a very simplistic view to say that there's a cause and effect. Again, going back to those college days, full employment was considered to be 5 percent or less, and yet CBO says—I mean, we've had 22 straight months of unemployment at below 5 percent. CBO says that that rate will be about 4.5 percent in this year and 4.7 percent in 2008. Again, just different view of the world.

Let me ask you, Dr. Furman, something that Dr. Holtz-Eakin said to Mr. Tanner in response to Mr. Tanner. We can't tax ourselves out of a problem. Do you agree with that?

Mr. FURMAN. I absolutely agree with that. I also would agree that we could not solve the entire problem on the spending side. I think both need to be part of the solution.

Mr. HULSHOF. Well, let me make sure you understand. Do you believe that we can tax ourselves out of this problem or that we cannot tax ourselves out of this problem?

Mr. FURMAN. I think taxes can contribute to solving this problem.

Mr. HULSHOF. So, in other words, you think that a nation can tax itself into prosperity. You reference such back in the 1990–1993 tax increases as somehow spurring economic growth. Is that your testimony?

Mr. FURMAN. I believe that both the 1990 and 1993 tax increases helped the economy by reducing the budget deficit, contributing to national savings and fostering capital formation.

Mr. HULSHOF. So, for instance, the 1993 luxury tax, was that a positive economic boon for, say, people that built boats or built luxury cars? Was that luxury tax then positive in the sense that certain sectors of the economy expanded as a result of that higher tax?

Mr. FURMAN. I haven't studied the individual provisions. Taken as a whole, increasing national savings can increase capital formation and increase economic growth. Reducing our budget deficit is one of the main tools that policymakers have to raise national savings.

Mr. HULSHOF. Final question. Do you agree then or disagree with the United States Treasury as they report that the top 5 percent of income earners pay a greater share of the nation's bills after the '01 and '03 tax reductions? Do you agree with the U.S. Treasury's report on that?

Mr. FURMAN. That is correct. Their share of income also went up over that period and——

Mr. HULSHOF. Their share or proportion of paying the bills here has also gone up even after the tax reductions. Do you agree with that?

Mr. FURMAN. When your share of income goes up, your share of taxes paid is going to go up as well.

Mr. HULSHOF. Thank you.

Mr. NEAL. We thank the gentleman. Another footnote to the gentleman. There were two former presidents that voted for that conference report in 1969 as well, President Ford and President Bush, Sr. both voted for it.

The gentleman from Texas, Mr. Doggett, is invited to inquire.

Mr. DOGGETT. Well, thank you so much for your testimony. We've endured 12 long years in this Congress where particularly, though not limited, but particularly in the area of taxation, logic, fact-based analysis was viewed with disdain, and mythology and ideology were very much on the ascendancy. It is good to hear all three of you reconfirm the obvious, even though it seems to be disputed by some on this panel, that tax cuts don't pay for themselves. That theory has been the underlying principle for the borrow-and-spend policies that we've endured for the last 12 years, and I view it as a form of modern alchemy.

As for no free lunches, to which Dr. Furman referred, we do still have at least 500-plus days of an Administration that believes in only free lunches now. The policies that we're looking at certainly have to consider that.

It was good to hear all three of you agree as well that we need to find more than a short-term fix for the alternative minimum tax. Now as to that tax and its origin, which has had some discussion, this hearing just happens to coincide with the recent passing of Leona Helmsley, who I guess will have as part of her legacy the richest dog in America, but she famously said that taxes were only for the little folks. I would ask you, Dr. Burman, as the person who's been designated as the expert on the AMT if you agree that the original purpose of the alternative minimum tax that even the richest Americans should share in contributing to the cost of our security and other necessary services of government if narrowly structured and implemented, still remains sound public policy?

Mr. BURMAN. The idea that somebody should pay a little bit of tax versus no taxes, that doesn't come out of any kind of economic principle or policy. The real issue is whether people were benefiting from tax breaks that were really unwarranted. My view is that in fact the best response for Congress in 1969 would have been to say, look, there are these tax loopholes that we've created, that they're taking advantage of. We should get rid of them for everybody.

The problem with the AMT is it says, well, we're going to trim it back a little bit so you don't embarrass us by taking too much advantage of these defects in the tax system. The better approach is to get rid of the loopholes across the board, not have two separate tax systems.

Mr. DOGGETT. With reference to how we correct the AMT on a longer term basis, as you're aware, we've had testimony from where you're sitting from the Bush administration that they don't like the AMT but they refuse to show us how we could correct it over a long period of time and pay for it. I don't believe any of our Republican colleagues on this Committee have suggested any way to pay for correction of the AMT, though they join all of us in saying that it needs to be corrected over a long period of time. What

would be the effect if we just followed the administration free lunch now approach and correct the AMT permanently or on a long-term basis and don't pay for a penny of the correction?

Mr. BURMAN. I think that would be a very unfortunate policy. For one thing, even though middle-class people are falling prey to the AMT, most of the tax is paid by people with relatively high incomes, $100,000 and over. So, eliminating the AMT by itself would be another large tax cut on people with pretty high incomes. It would make the tax system even less progressive.

The other thing is that it would reduce tax revenues by $800 billion over the next 10 years. As we've all discussed, the revenue demands on the government are going to be unprecedented over the next 10 years and beyond, and I think that would be problematic.

Mr. DOGGETT. Dr. Furman, do you agree with that?

Mr. FURMAN. Yes, I agree with that.

Mr. DOGGETT. Dr. Holtz-Eakin, do you believe we can correct the alternative minimum tax over a long period of time without paying for it any way?

Mr. HOLTZ-EAKIN. I echo what Dr. Burman said, which is this should be fixed in the context of the whole Tax Code. We've seen examples of, you know, not because I like all the particulars, but the President's Advisory Panel put out plans that got rid of the AMT, broadened the tax base, you know were revenue neutral, and that's the route to go.

Mr. DOGGETT. Dr. Burman, then, unless we find a way to pay for the alternative minimum tax correction, and you referred in your testimony to some of those, and Chairman Neal has taken a lead on that, there's really no way that this inequity can be corrected for the millions of American families that are either being impacted today or will be impacted in the future. Is that correct?

Mr. BURMAN. Well, you could just eliminate it and increase the deficit. But if you're not willing——

Mr. DOGGETT. Well, let me say no responsible way to correct this inequity unless we find a way to pay for it?

Mr. BURMAN. I think revenue neutral reform is definitely the best approach.

Mr. DOGGETT. Thank you.

Mr. NEAL. Thank you. With the consent of Mr. McCrery, because there are more Members on this side rather than this side at the moment, we're going to do two, and Mr. Becerra is recognized to inquire.

Mr. BECERRA. Thank you, Mr. Chairman. I thank the panel for their testimony. Appreciate it very, very much as we try to formulate some sound policy to address some of the concerns that taxpayers have expressed to us over the years.

Let me try to touch on one point for 1 second. My understanding is that we have a civilian workforce being—not counting the military—of something approaching 150 million Americans who are employed. Today we have an unemployment rate hovering somewhere around 4 percent, 5 percent. There are some 7 million, close to 7 million or so Americans who are unemployed. I make this comment only because my friend and colleague, Mr. Hulshof, made the point that full employment has often been described as being 5 percent, only 5 percent of Americans unemployed. I think we have to

dispense and dispose of that type of thinking that we can call full employment 7 million Americas, more than 7 million Americans in this economy, without work. I think that's one of the difficulties that I think economists run into and policymakers. When we talk about full employment, meaning when we've got 95 percent of Americans employed, or in this case, over 7 million Americans, that means they're out of luck, and we would totally discard them in our consideration of our policies if we feel we're under an economy with full employment.

I think that's one of the reasons we have these difficulties today with regard to tax policy. When we hear people talk about tax cuts being the savior for the economy and for the American worker, I think all three of our witnesses, our expert witnesses, have said that tax cuts by themselves do not pay for their costs. If that's the case, the Bush tax cuts don't and won't pay for themselves either. Now that we find that it's really as a result of the Bush tax cuts that this alternative minimum tax problem will begin to hit more and more Americans that never thought that they would be lumped in with Exxon Mobil and all these other very lucrative companies and very, very wealthy Americans, it's because we have policies that seem so out of touch here in Washington compared to what's going on in average America. I think we do have to come up with a more rational approach.

To me, the AMT is a symptom of our very chaotic Tax Code that tries to address general problems, but when you actually come down to it, the special interests get a better grip on the policy than do average Americans, and what we end up with is not what we thought we would conclude with it, quite honestly.

My question to the three of you, whoever would like to answer this, is the following. If we do AMT relief, to whom should we target it?

Mr. BURMAN. My preference would be to eliminate the AMT altogether and make up the revenues by making the tax system more progressive. The problem with the AMT is that it's hitting people whom it was never intended to hit. Certainly somebody earning $75,000 and taking the standard deduction was never the intended target of the AMT. They didn't choose to have their children as a tax shelter device. Even if they did, they probably should still be applauded because they're helping with the long-term entitlement problem.

Mr. BECERRA. So, Dr. Burman, I sense what you're saying is, to make the Tax Code more progressive and to try to eliminate the disparities that we see today that middle class and modest income working families seems to be paying a greater share of their income in taxes than do those who are becoming very wealthy, that you would make it more progressive and therefore tax—make sure the Tax Code reflects that the more—the higher your income, the more you're going to pay in taxes?

Mr. BURMAN. Right. The original intent of the AMT was to make sure the people who in current dollars would be millionaires were paying at least some tax, and the 4 percent surtax that I laid out would be one simple approach to do that. It would take the AMT completely off the backs of couples earning less than—$200,000.

Mr. BECERRA. You wouldn't AMT if you had a progressive Tax Code because you'd always make sure that people are paying their fair share of taxes?

Mr. BURMAN. Right. It would be nice to broaden the base and get rid of the unwarranted loopholes. That might even allow you to lower marginal tax rates, which would make Dr. Holtz-Eakin and the rest of us happier.

Mr. BECERRA. Dr. Holtz-Eakin, I sense that you may want to respond.

Mr. HOLTZ-EAKIN. I think he said something with which I disagree. I mean, you don't always need an AMT to have a progressive tax. You shouldn't have an AMT. The AMT is an acknowledgement that the tax system is broken. The basic job of constructing a Tax Code that raises the revenue in a sensible fashion has not been accomplished. It's not that the AMT is there to make sure that high-income people pay more taxes. It's to make sure that they don't exploit the loopholes provided legally in the regular tax in order to not pay taxes.

So, be clear. The goal is not to have an AMT, because that would say, gee, we want to continue to fail at having a sensible Tax Code. No. We do not want to have that as the goal. How to target the AMT, I have no good guidance to give you. We don't have a tax system that has any foundation in terms of trying to meet objectives of fairness. It taxes high-income people who are productive, employing people, eager to improve the surroundings, are donating money to charity, the same as high income people who are slugs. That makes no sense to me. So I don't see how you ethically fix a tax system that has no ethical foundations. I wish you luck.

Mr. BECERRA. I appreciate your answers [continuing]. Thank you very much, Mr. Chairman. I yield back.

Mr. NEAL. Thank you. The gentleman from Kentucky, Mr. Lewis, is recognized to inquire.

Mr. LEWIS OF KENTUCKY. The American people feel very simply this way, I do not think they feel like they do not pay enough taxes. I think their concern these days is how much the government is spending. Dr. Burman, your testimony shows a chart indicating that about 16 percent of all income is earned by the top 1 percent. Treasury and CBO data show the share of individual income taxes paid by the top 1 percent is about 37 percent. Does this suggest the Tax Code is progressive in imposing greater burdens on higher income earners. That goes without saying.

Mr. BURMAN. The Federal Tax Code overall is progressive.

Mr. LEWIS OF KENTUCKY. If 37 percent is not enough, then how much would you like to see the top 1 percent pay? I think that is what I am trying to get here today: what is fair?

Mr. BURMAN. It is actually not up to me to make that decision, you as the elected Representatives have to reflect what the people's preferences of the public are. People in polls overall, over the last 50 years anyway, have supported the idea of a progressive tax system where high-income people pay a larger share of their income in tax than lower income people. My personal view is that high-income people are doing so well that they could probably afford to carry more of the burden. They have gotten the largest gains from the economic growth over the last 20 years but it is really your call.

Mr. LEWIS OF KENTUCKY. What share of taxpayers, and this is not a question, 37 percent of all income taxes are paid across the board by 90 percent of the lower income. The other question is should the upper income folks take over more of that burden or take over all of that burden?

Mr. BURMAN. Well, there is certainly an argument for having everybody pay at least a little bit of tax. That said, low-income people are in a situation where they really need help from the government. One nice approach is the refundable earned income tax credit, which can offset the income tax liability of people who are working and cannot afford to feed and clothe their families.

I should also point out that if you just look at the income tax data, you get a somewhat misleading picture because most American families pay more in payroll taxes than in income taxes. If you look at taxes overall, payroll, excised income and state taxes, people at every income level are paying positive tax liability, it is relatively low at the bottom and around 20 to 25 percent at the very top. Even at the top, at the very top of the income distribution, people get to keep something like three quarters of the income that they are earning.

Mr. LEWIS OF KENTUCKY. Mr. Tanner of course I think brought up the ultimate question, government expense is growing faster than what eventually we can tax the American people to keep it going, The PAY–GO rule, if we are going to spend more, we are going to have to figure out how to come up with the money, cut spending somewhere else or increase taxes. What is the breaking point for the American people? Wealth is created in the private sector, not in government. There comes a point when we kill the goose who is laying the golden egg and, as has been said here today, we cannot tax our way out of it but we are going to reach a point where we cannot grow the economy to meet the cost. So, we are going to have to come up with some good tax policy, and we are going to have to come up with a way to provide the necessary programs for the American people without breaking them. So, anyway I yield back. Thank you.

Mr. NEAL. We thank the gentleman. Mr. Pomeroy is recognized to inquire.

Mr. POMEROY. Well, I like my colleague's phrasing, I think he has squarely put forward an economic view and ideological view of the whole supply side economic theory that is addressed in this month's New Republic. I would just like to quote from an article discussing this theory: "Supply side economics is not merely an economic program, it is a totalistic ideology. The core principle is that economic performance hinges almost entirely on how much incentive investors and entrepreneurs have to attain more wealth and that this incentive in turn hinges almost entirely on their tax rates. Therefore, cutting taxes, especially those of the rich who carry out the decisive entrepreneurial role in the economy, is always a good idea." I would like to ask our economists, each of whom I have great respect for and think that you draw your conclusions based upon the numbers, whether there is history to support this view, that in the end our ability to grow the economy depends on whether people invest and whether people will invest depends upon how much their tax rate is and so that reducing the tax rate always

brings more investment? Let's start with you, Dr. Holtz-Eakin. I have got several more questions, I guess two more questions, so if we can do it quickly.

Mr. HOLTZ-EAKIN. First and foremost, I do not think any of the major Ph.D.-granting economics departments uses The New Republic to teach economics, and so I would encourage us to look for more informed sources.

Mr. POMEROY. Actually, just to reclaim the point, I do not quote The New Republic as an economic source, I do think this particular article in doing an analysis on the economic basis of the supply side economic theory offers value for our discussion today. In that respect, is there economic data that supports the view that a further reduction in tax always produces more incentive to invest and therefore the more you cut taxes, especially on the rich, it guarantees economic growth?

Mr. HOLTZ-EAKIN. Every economist is trained that economic growth is a supply side phenomenon in the following sense: To grow, you must expand your capacity to produce by giving up something today and investing in either greater physical, intellectual——

Mr. POMEROY. No, no, in the filibuster, is that completely related, Dr. Holtz-Eakin——

Mr. HOLTZ-EAKIN. No, no, that is actually, with all due respect——

Mr. POMEROY [continuing]. Into the tax rate applied?

Mr. HOLTZ-EAKIN. With all due respect, if you want to answer the question correctly, you have to frame it correctly and so the question is how do you accumulate technology, physical capital, human capital, skills which allow the economy to be more productive? The answer is through incentives. Now where do taxes fit in that? Taxes impair incentives and so you should only use taxes to impair incentives if there are beneficial public programs that they need to finance period. You should not ever raise taxes——

Mr. POMEROY. You are not answering my question and you are burning up my time, so let me ask you is the decision to invest or not invest hyperlinked to the tax rate? Is that the principal driving issue driving entrepreneurial investment in our economy?

Mr. HOLTZ-EAKIN. It is inextricably linked to taxes, they are part of the rate of return. No way to take it out.

Mr. POMEROY. Of course it is a factor, is it the principal factor so that cutting taxes, especially those on the rich, will always produce economic growth?

Mr. HOLTZ-EAKIN. Those are two different things.

Mr. POMEROY. Okay, you apparently have no interest in answering the question, move to the next panelist.

Mr. FURMAN. An important determinant of national investment is national savings and, as I have talked about before, in the nineties we had higher tax rates, we also had higher rates of investment, higher rates of savings, higher rates of job growth. So, clearly the Tax Code in the nineties was compatible with very strong economic growth and, as I said, I believe it contributed to that strong economic growth by fostering national savings. There is more than just taxes that matter for economic growth. I am a supply sider, I agree with Dr. Holtz-Eakin that it is the supply side

that can create growth in the long run but for that supply side, you need high national savings, you need for example investments in the NIH, which went up in the nineties and have been cut in real terms in recent years. There are a lot of elements to a strategy for supply side economic growth that have nothing to do with lower taxes.

Mr. POMEROY. Pursuing the national savings issue, and, Dr. Burman, we will give you a shot at the question, but pursuing the national savings issue, I have distributed a chart and it is displayed and it tracks the national savings rates. You will see that the government savings, the bottom line goes into surplus but sharply into deficits featuring in part the revenue loss of the tax cuts passed under this administration. But as you look, even though those deficits while still in deficit and no longer a surplus, seems to be abating a little, the national savings rate has plummeted and is actually in deficit. So, the question then raises, Dr. Furman, has the tax cut strategy we have embarked upon under this administration produced an increase in national savings or has it actually potentially contributed to a national savings problem?

Mr. FURMAN. Right, I would say almost any economist would agree that our National savings rate is between one and 2 percentage points lower than it otherwise would have been if we had not had the tax cuts that were passed beginning in the year 2001, without the tax cuts we would be saving one to 2 percentage points more depending——

Mr. POMEROY. With the Chairman's leave, could Dr. Burman briefly respond to the first question, basically the Laffer Curve question?

Mr. BURMAN. It depends, I think this is what Dr. Holtz-Eakin was trying to say, on how you cut taxes. If you cut taxes by broadening the tax base, holding revenues constant, most economists would say that that would encourage savings, investment and economic growth. If you do what we did in 2001 and 2003, borrow the money to finance the tax cuts, on the one hand individuals might have an incentive to save more, businesses to invest more, but the government is borrowing more and that is draining the capital that businesses need to finance for investment, increasing interest rates. The other thing is looking at the savings rate, it is hard to make personal savings move. Almost all the economic evidence suggests that personal saving is relatively unresponsive to tax rates. I am not saying there is no response but it is very small. So, basically tax cuts can be good for the economy, they could be bad for the economy. Tax increases is the same thing.

Mr. POMEROY. But if you are going to have tax cuts that are good for the economy, they should be paid for so you do not drive the deficit deeper. They should be broad-based and the distribution tables we have seen of the tax cuts recently enacted during this administration show disproportionate effect to the wealthiest few, probably not spurring deeper investment. They already had the money to invest. I yield back.

Mr. NEAL. We thank the gentleman. The gentle lady from Ohio, Ms. Tubbs Jones, is recognized to inquire.

Ms. TUBBS JONES. Thank you, Mr. Chairman. I want to salute you or celebrate you for all the work that you and the Chairman

have been doing in this area. I am pleased to have an opportunity to participate in this discussion, particularly about AMT. I am looking at some statistics that arise from the 11th Congressional District of Ohio and the people who are impacted by this imposition. I am personally of the belief that we need to do more than put a bandage on the AMT, that we need to in fact implement it such that it is taken care of over a period of time so that taxpayers, much like businesspeople, have a knowledge about what is going to happen in the future for their planning.

I in fact have two letters from my constituents, one dating back to—originally back to 2005 in March and it comes from a young man by the name of Tony Mastrioani, and he says, "When we worked together in the prosecutor's office, we prosecuted matters deemed criminal by statute. For how it will potentially decimate our district and others, alternative minimum tax ought to be considered criminal. The AMT increased my Federal tax liability by over $13,000. This increase did not result so much from my income level but rather was directly related to the fact that Cleveland Heights has among the highest property tax rates in the state and the state of Ohio is among the states with the highest income tax rate." It goes on to talk about what he thinks we ought to do to fix the AMT.

Another letter from another constituent of mine by the name of Doug Bondman says, "I am writing to strongly encourage you to repeal, re-write the AMT statute. As you are probably aware, when the AMT was established, there was no provision for inflation adjustment." So I am concerned that this administration, in the course of trying to fix taxes, has failed at any point other than say we will fix it year by year. I am only going to give a short amount of time, answer that question for me first, Mr. Furman, your position or your comment with regard to what I have discussed about AMT? Burman, I am sorry, Mr. Burman, I apologize.

Mr. BURMAN. I completely agree with you that the AMT ought to be eliminated. I do not think it has a place in the income tax and there are a number of options to do that in a fiscally responsible manner and it would be great for you to do it.

Ms. TUBBS JONES. Mr. Furman.

Mr. FURMAN. I agree with that as well. I would like to say as part of a broad tax reform, it would be wonderful to get rid the AMT. The AMT should not be necessary. If this Committee were able to undertake something that eliminated the AMT for the vast majority of people that paid it but still kept it in place for higher income people, I think that would also be a very substantial contribution to improving tax policy in this country.

Ms. TUBBS JONES. Mr. Holtz-Eakin, I am going to switch to another subject matter. Did I hear you say that there was no ethical standard in our taxing policy, is that what you said?

Mr. HOLTZ-EAKIN. When I see the U.S. income tax, I do not see anything that looks like a coherent approach to taxation that is based on single standards for raising revenue, achieving economic efficiency and having some notion of fairness.

Ms. TUBBS JONES. So, you do not really intend to use the term "ethical?" You know I am chair of the Ethics Committee so I am concerned about what you are saying the conduct of Members of

Congress as ethical, so you do not really mean that it is not ethical?

Mr. HOLTZ-EAKIN. One can look at pieces of the Tax Code and wonder if they have an ethical foundation that we would not be proud of because there is no place in a good Tax Code for rifle shot provisions that——

Ms. TUBBS JONES. Maybe you ought to define "ethical" for us?

Mr. HOLTZ-EAKIN. What are you trying to achieve with the Tax Code? What is the standard of fairness? Mine would be that we should tax people more if they take more out of our economy. We should tax them on that basis, not on the basis of what they contribute. Income is a measure of what you contribute to an economy. It is your labor, it is your capital, it is your skills and energy. Consumption is what you take out.

Ms. TUBBS JONES. Mr. Eakin, thank you. I am running out of time. I have one more question. Tell me in two or three words, each of you, how you can say, if anybody says that the tax policy does not cause inequality in this country? Tax policy absolutely causes inequality in this country even if it is based on the income of the people, we are looking at the fact that the income in this country has separated, that there are more rich people and more poor people than ever. There is this disparity, how is it that tax policy could not have an impact?

Mr. BURMAN. The point we were making I think that it is not likely it is a major factor in the distribution of pre-tax income. My position is that the income tax plays an important role in the distribution of aftertax income, that is it can mitigate the effects of rising economic inequality. Of course, over the last 6 years, the tax system has actually been going in the opposite direction and becoming less progressive at the same time that pre-tax incomes have been spreading out.

Ms. TUBBS JONES. So, you are saying it has become less progressive and therefore it has a greater impact on the income of folks?

Mr. BURMAN. On aftertax income, which is of course what matters to individuals.

Ms. TUBBS JONES. One more answer and then I am done. Mr. Furman.

Mr. FURMAN. The changes in the tax policy have not caused the increase in inequality but had we not changed tax policy, then the Tax Code would have solved a meaningful portion of the inequality.

Ms. TUBBS JONES. But the fact that the way our tax policy operates, it operates in the interest of people giving to charity and charity impacts those at the lower income stream because are more generous only because the Tax Code allows them to be generous?

Mr. FURMAN. Oh, aftertax income is higher this year than it would have been in the absence of the tax cuts enacted starting in 2001.

Ms. TUBBS JONES. I am out of time. Thank you.

Mr. NEAL. I thank the gentle lady. The gentleman from New York, Mr. Reynolds, is recognized to inquire.

Mr. REYNOLDS. I thank the Chairman for holding this important hearing, which touches two critical tax policy issues that I have been involved with for some time: the tax treatment of carried

interest and the tax relief from the AMT or, as I like to call it, the "stealth tax." I want to take a moment to talk about a few key aspects of these two key issues, both because they have such an enormous impact in my home state of New York, as well as the country as a whole. Let me make three specific points about the Levin-Rangel proposal to raise taxes on investment partnerships by reclassifying their carried interest as ordinary income rather than capital gains.

First, the Democrats are using Blackstone as a Trojan horse to smuggle into law higher taxes on capital gains. Anyone who thought the new Democratic majority might actually wait until 2010, the year the lower taxes on capital gains and dividends are scheduled to expire, to raise taxes on investments should be concerned. This bill is likely just the first of many legislative assaults on the very tax incentives that have helped create 8.3 million jobs over the past 4 years, a period that has seen net job growth of 47 consecutive months. Indeed, Democrats' new PAYGO rules will inevitably force them into additional massive tax increases in order to fund their voracious appetite for spending. While certain Wall Street fund managers may be easy political targets, it is clear the new majority is using Blackstone as the Trojan horse to sneak through far broader tax increases. But the truth is that the 2003 tax cuts have worked. Mr. Chairman, notwithstanding some of the revisionist history we will hear today that we have already heard and will hear, particularly with the recent turbulence we have seen in the credit markets, now is not the time to make an economic u-turn by raising taxes, especially when those tax hikes would discourage capital investments.

Second, this proposal would have a profound impact across our National economy, from Wall Street to Main Street. Proponents of the carried interest rate tax hike claim they are only going after wealthy private equity hedge fund managers, the Wall Street "fat cats" that so offend Democrats' notion of tax fairness. However, the Levin-Rangel bill would actually affect not just private equity and hedge funds but partnerships across the spectrum, from small venture capital firms to local real estate partnerships in each of our communities.

When Democrats use the phrase "tax fairness," watch out, it always seems to translate into tax increases on the middle class. Indeed, not just investment partnerships themselves will be affected by the Levin-Rangel proposal. Lost in all the political rhetoric is the fact that university endowments, charitable foundations, and public and private pension plans are among the biggest investors in private equity and hedge funds. For example, New York's common retirement fund, the nation's third largest public pension fund with over one million members, retirees and beneficiaries, have made substantial investments in private equity and other alternative investment vehicles. It helps bring the consequences of this proposed tax hike into focus when we remember that grandma's retirement security may be at stake.

Third, this proposal would hurt U.S. competitiveness in global financial markets and further undermine New York's position as the preeminent financial center of the world. As the sole Republican Member on this Committee from New York, I am particularly con-

cerned that this legislation would make a bad situation worse for U.S. competitiveness in international capital markets, especially in the wake of Sarbanes-Oxley. Though well-intentioned, Sarbanes-Oxley is now widely viewed as having put a significant drag on our economy and having undercut our capital market competitiveness where once New York was unquestioned global headquarters for capital formation. For example, billion dollar IPOs now occur far more regularly in London and Hong Kong. Unfortunately, the damage Sarbanes-Oxley has caused through excessive corporate regulation would only be compounded by the Levin-Rangel carried interest proposal through higher taxes on investment partnerships. The last thing Congress needs to do is give investment partnerships new reasons to explore their global options by imposing new taxes on entrepreneurial risk taking here at home.

Let me turn briefly to AMT. The new majority talks a good game about wanting to solve the AMT problem but history shows that Democratic majorities created the AMT regardless of the vote outcome in 1969, made it worse in 1993, opposed full repeal of this unfair stealth tax in 1999. Republicans on the other hand have consistently enacted legislation to limit AMT's growing reach into the middle class during our years of the majority. As author of the House Middle-Class AMT Relief bill for 2006, the Stealth Tax Relief Act, I was pleased that Congress was able to enact the most recent temporary patch without raising taxes and with an overwhelming bipartisan vote of 414 to 4. But now more than 8 months have come and gone since that temporary relief expired, and we are still yet to see an actual proposal from House Democrats on how to address the AMT.

While I had originally hoped that we could have used these past few months to make bipartisan progress on long-term AMT solutions, the time has come to begin focusing our attention on a realistic temporary fix for middle class America stealth tax. Just as Senator Bachus has recommended and just as we did in 2006, we should enact that critical relief without raising taxes somewhere else.

I thank the Chairman and yield back the balance of my time.

Mr. NEAL. We thank the gentleman. The gentleman from Connecticut, Mr. Larson, is recognized to inquire.

Mr. LARSON. Thank you, Mr. Chairman. Mr. Chairman, let me acknowledge your work and that of Chairman Rangel to provide 90 million Americans with direct tax relief finally. A lot of crocodile tears on the other side of the aisle about everything that would have, could have, should have. It has taken the leadership of Mr. Neal and Mr. Rangel to bring this to fruition, and I commend you both for that. I also commend our analysts today (a) for your endurance and your willingness to take a number of obvious important questions as it relates to this subject matter before us. The first question I have because it is always good discussion here on the Committee is I believe it was Milton Friedman who famously said, "To spend is to tax." Are tax cuts simply another form of spending?

Mr. FURMAN. No, what he meant is that if you lower taxes today at the same time that you raise spending, which is what we have seen for the last 7 years, you are not actually lowering the

long-term tax burden, you are shifting taxes by borrowing money today, which necessitates for any given level of spending even higher taxes than you would otherwise have had in the future. So his point—and I know a number of conservative economists who have argued that the tax cuts enacted in recent years do not need an economic definition of tax cuts because they have been accompanied by higher debt and will lead to higher taxes in the future.

Mr. LARSON. Well, if that logic follows through, would refusal to extend the Bush tax cuts simply be a choice not to spend more money to the wealthy?

Mr. FURMAN. It would be a choice to borrow less and would mean that we would need less of a tax increase in the future when our entitlement problems are severe.

Mr. LARSON. Do the other panelists want to comment?

Mr. HOLTZ-EAKIN. I think it is really simple, the threshold issue is do you spend the money, so do you authorize and appropriate money out of the Federal budget? Once you do that, you are going to pay for it. If you choose not to raise taxes this year, you will borrow and raise taxes to pay off that debt. There is no way around that. His point was simply if you commit to those resources in the public sector, you will take them from the private sector one way or another.

Mr. BURMAN. There used to be a commercial for a muffler company saying, "You can pay me now or you can pay me later." Basically if you spend money, you have to pay for it. You can pay for it with current taxes or future taxes or future spending cuts.

Mr. LARSON. I believe it was the Fram Oil commercial as a matter of fact and so the American public is paying now and will be paying later.

With respect, Mr. Furman, in the Hamilton Project paper you coauthored, you wrote, "As capital moves more quickly across borders, capital income becomes increasingly elusive of tax." It often seems to me that there are separate sets of rules for different people and that this contributes greatly to income inequality. We are very good at taxing wages, people fill out W–2's and the employer withholds the tax and so forth. In this age of globalization, it seems there are more and more ways of making money and often the IRS and Congress itself cannot keep up. So, my question is, I hope you will all join in, but are sophisticated financial systems making it easier for corporations to avoid paying taxes? If so, how do we make the rules, i.e., the Tax Code, more fair to ensure that everyone can benefit from globalization? Are we now in the 21st century working with a Tax Code that was designed for another century? If so, how do we remedy this?

Mr. BURMAN. I think those are probably the hardest questions that will be facing us over the next couple of decades. It certainly is true that globalization and technology have made it harder to sustain a tax base. Some people would say, well, the problem is you are trying to tax income but, as Dr. Holtz-Eakin has pointed out, that exempting the return to savings or exempting savings from taxing under a consumption tax does not solve the problem, you shift it. Right now we have to measure income. People try to hide income from the Treasury. If we said we were only going to tax spending, then people would make wages look like spending. The

best thing is to eliminate as many loopholes as possible, to broaden the base and keep the rates as low as you can while maintaining revenues. One thing we all know is that the rewards for tax avoidance and evasion go up the higher the tax rate is, so that puts a huge premium on having a relatively efficient tax system.

Mr. LARSON. Mr. Furman.

Mr. FURMAN. I would say there are some places where there are disagreements between the parties and between the different persuasions, like the level at which you want to tax capital. One thing we should all agree on though is that you want to tax it in a consistent and coherent manner. So, for instance, it is indefensible that debt-financed investment right now, corporate investment is taxed at negative 6 percent. No one would defend that at the same time that equity financed corporate investment is taxed at 36 percent. So, the substantial scope for making the tax rate that you pay on different types of activities, corporations, partnerships, debt, equity, different forms of investment at the business level, at the individual level, making those more coherent. Once you are paying similar tax rates on different types of activities, you can make those tax rates lower, you can reduce the rewards to financial planning, and you can do a better job of dealing with some of those challenges in terms of technology, financialization and globalization that have been eroding our tax base.

Mr. LARSON. I see that my time has expired. I do not know if the Chairman——

Mr. NEAL. I thank the gentleman. The gentleman from Oregon, Mr. Blumenauer, is recognized to inquire. There are four votes on the House floor. We will move to Mr. Ryan next after Mr. Blumenauer.

Mr. BLUMENAUER. Thank you very much, Mr. Chairman.

Chairman RANGEL. I really do not know whether we have time to do this in the regular order, notwithstanding the fact that those who have not inquired want to inquire. It would mean bringing the panel back, and I guess that would be close to 45 minutes. However, if there are people who are scheduled to speak that would be willing to yield and be the first ones to come back to testify, if that is so, it would prevent us from having to bring the panel back. So, let me informally ask, among those who are about to inquire, any of you willing to be the first to inquire of the second panel by yielding so that we can dismiss this panel?

Mr. BLUMENAUER. If that is your preference, Mr. Chairman, I am happy to relinquish——

Chairman RANGEL. Is there anyone who would have a problem with it but that would prefer that the panel come back? There is no way in the world for us to do this anyway. The only question is whether or not those who want to continue would have the panel come back. If you put up your hand and say you want them to continue, then they will have to come back even if it is only one. But if unanimously you are prepared to say that you will accept the priority in terms of those of you who have not questioned the panel, then it will make it easier for us to go vote and then do that. As a matter of fact, I would ask that you consider that, would you? Well, by unanimous consent, we want to thank this panel because they have agreed to come back.

Mr. RYAN. Mr. Chairman? We still have about 5 minutes left, can we do about 5 minutes before they leave?

Chairman RANGEL. Yes, it will be a Democrat that is up for 5 minutes, will that help you at all?

Mr. RYAN. I have got one question.

Chairman RANGEL. No you do not because you are not next. Mr. Blumenauer has got 5 minutes.

Mr. RYAN. No, after Earl. We have what 6 minutes left on the clock?

Mr. NEAL. There is time for Mr. Blumenauer to inquire.

Mr. RYAN. Look, it is fine, I am just saying we can run this thing out to the end, then let's dismiss the panel. That would be all I would suggest. Let's use up what time we have and then dismiss the panel.

Chairman RANGEL. Okay, Mr. Blumenauer, I am asking to yield to the gentleman, yield to you for your questions.

Mr. RYAN. Thank you.

Chairman RANGEL. I would just like to hear the question though.

Mr. RYAN. I just had one quick question I wanted to ask.

Chairman RANGEL. I want to listen to it.

Mr. RYAN. Wonderful. I wanted to ask each of the three of our economists, this is probably a yes or no answer, do you believe that a lower capital gains tax rate on capital gains is appropriate? Then I have one follow-up. Let's just start with you, Mr. Burman, and go down the line.

Mr. BURMAN. Sorry, a lower capital gains tax rate?

Mr. RYAN. Is a lower capital gains tax rate a good thing, is it appropriate?

Mr. BURMAN. No, I have a book on the subject.

Mr. RYAN. I realize that. Mr. Furman and Mr. Holtz-Eakin.

Mr. FURMAN. I would like to see us move toward a more consistent way of taxing capital and business income and that consistency is more important to me than the ultimate rate that you end up at.

Mr. HOLTZ-EAKIN. Yes.

Mr. RYAN. Okay, Mr. Burman, because you have written most extensively on this, you just did this very interesting op-ed in the Washington Post about a month ago where you basically conclude, and correct me if I get this wrong, that the whole debate about carried interest, really if they want to get this right from your perspective, which is not to tax carried interest at the capital gains rate, instead of just plugging this particular loophole so to speak, we should just get rid of the lower preferential rate on capital gains altogether and that if they do not do that, if they are short of that, then smart people will get around whatever block Congress puts in front of it, like the Rangel-Levin bill, and they will find another way of taxing carried interest at 15 percent instead of the higher 35-percent rate which you seem to advocate they ought to go to, is that correct?

Mr. RYAN. I would eliminate capital gains tax rate except in the case of corporate stock where there is an argument for providing a credit for taxes paid at the company level. So, putting something in the Code to prevent carried interest from being taxed as capital

gains, from your perspective the only real way to do that is simply to eliminate the preferential tax treatment on capital gains itself and then, as you mention, on double taxation on corporate tax credits, is that basically what you are saying we ought to go to?

Mr. RYAN. If you cannot fix the capital gains tax regime overall, it would make sense actually to get rid of the tax break and to move in the direction of the right taxes, which is taxing these things that seem to be gains as income. So, I would not agree with that.

Mr. RYAN. I just think it sheds light on where this ultimate debate kind of ends up going. I thank the Chairman for his indulgence.

Mr. NEAL. I thank the gentleman. Mr. Davis has asked that he be allowed to use 1 minute to get to the panelists.

Mr. DAVIS. Thank you, Mr. Chairman. I just want to pose one question and invite whichever one of you wants to take it, a swing at it. One of the ironies to me, when the administration sent up its budget earlier this year, there was a very interesting contradiction. As it has done the last several years, the administration resumed permanence of the 2001 and 2003 tax cuts and made a number of representations about their essentialness to economic growth and job creation. At the same time, the administration beyond a 1 year fix, presumed that the AMT levels would continue to escalate over the next several years. I thought that was a striking contradiction. If we are concerned about tax rates impacting economic growth, it would seem to me that we would be equally concerned about the AMT levels. Do any of the three of you, perhaps you Dr. Holtz-Eakin, want to comment on that contradiction and whether you were struck by it as well?

Mr. HOLTZ-EAKIN. I did not read the budget carefully enough to be struck by it but the bottom line is the Tax Code affects growth through its incentives on——

Mr. DAVIS. Well, just speak to that point, do you see that as a contradiction or any one of you want to speak to that?

Mr. HOLTZ-EAKIN. All marginal tax rates matter whether they are AMT or otherwise. That is that.

Mr. RYAN. Dr. Furman.

Mr. FURMAN. I think it essentially is not a budget, does not even meet the definition of a budget if it does not include a set of very predictable things both on the tax side and spending side in the future.

Mr. NEAL. I want to thank the panelists, as usual, most informative and delighted you were here. The Chair will declare the Committee in recess.

[Recess.]

Mr. NEAL. We will begin to receive testimony.

Mr. Shay, we would like to welcome you to open testimony for the second panel.

Mr. SHAY. Thank you, Mr. Chairman. My name is Stephen Shay. I am a partner at the law firm of Ropes & Gray. The views I am expressing today are my personal views and do not represent the views of either my clients or my law firm.

With the Chairman's permission, I would like to submit my testimony for the record and summarize my testimony in hopefully brief oral remarks.

Mr. NEAL. So, ordered.

STATEMENT OF STEPHEN E. SHAY, PARTNER, ROPES & GRAY, LLP, BOSTON, MASSACHUSETTS

Mr. SHAY. I will direct my testimony toward how fairness concerns may be taken into account in U.S. tax rules relating to the taxation of foreign business income, that is income earned from conducting economic activity outside of the United States. There is a joint Committee pamphlet that has a good summary of our international tax rules so I will not cover those.

I have previously testified that the current U.S. rules for taxing international income, foreign income, while complex do represent the best of all worlds for U.S. taxpayers engaged in international activity. Taxpayers that are earning high tax foreign business income can use excess foreign tax credits against other low tax foreign income. The effect of this cross-crediting is to provide an incentive to a taxpayer with excess foreign tax credits to earn low taxed foreign income and then to credit the high foreign tax against the U.S. tax on this low foreign tax income. So, the current state of our credit rules does provide an incentive to invest to earn foreign income that is subject to lower taxes.

In addition, allowing U.S. taxation of foreign, active foreign business income earned through a foreign corporation to be deferred until repatriated as a dividend subject to some anti-deferral rules encourages investment in lower tax foreign countries. Over a long enough period, the difference between the foreign effective rate and the U.S. effective rate can be quite valuable in an even appropriate—I'm sorry, even approach exemption. In practice, the current U.S. system of worldwide taxation with elective deferral of U.S. tax on foreign corporate business income while complex can be managed to achieve very low effective rates of tax on foreign income. Indeed, the overall effect can be more generous than an exemption system for taxing foreign income.

There is no o priori reason for taking foreign income, which is subject to these benefits, and excluding it from a fairness analysis as we would the taxation of other income in the U.S. system. In other words, there are some special considerations with respect to international income but at the end of the day, it is part of the overall U.S. tax system and should be evaluated under the same criteria that we evaluate the taxation of other forms of income.

If the U.S. taxation of foreign business income is lower than on domestic business income, U.S. persons who do not earn the foreign business income will be subject to heavier taxation solely because of where their business or activity is located. This violates the ability to pay norm and can be justified only if there is an identifiable benefit to individual U.S. citizens and residents.

In my testimony, I have explained why I think a limited foreign tax credit that does eliminate double taxation is justifiable even though on its face it is inconsistent with an ability to pay criterion. I go into that in the testimony.

But I do conclude that our current rules do permit excessive crediting of foreign taxes and to some extent that is illustrated by the fact that if you go to an exemption system, we actually would, it is estimated we would raise revenue and that is a result of the fact that under our current system we can cross credit foreign taxes to a point that you get more of a benefit than you would if you just exempted foreign income altogether.

In my testimony, just outlining at a very high level some thoughts for how one might address the current rules. I respectfully submit that reducing the scope for deferral and more closely aligning the foreign tax credit rules to the purpose of avoiding double taxation should be supported on the grounds of fairness as well as sufficiency.

I want to make a note about inter-company transfer pricing. A taxpayer's ability to control inter-company pricing is a fundamental attribute of international taxation. The necessary flexibility of tax rules relating to transfer pricing, that is to allow taxpayers to carry on their businesses, is a critical factor in assessing a structure of those rules. In order to restrict transfer pricing abuse, the focus must be on reducing the effective tax rate differential between earning the foreign income and the U.S. income and that is the thrust of the direction of the changes I would support, as I have said, on both fairness and efficiency grounds.

The current foreign tax—I'm sorry, reducing the scope for deferrals would be a key element and improving the foreign tax credit by repeal of the sales source rules and rationalization of source rules for taxing income from intangibles would contribute in this regard.

The changes that I describe in my testimony would move toward equalizing the taxation of foreign and domestic business income and the results, I submit, would be a fairer tax system.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Shay follows:]

Statement of Stephen E. Shay

Committee on Ways and Means
United States House of Representatives

Hearing on Fair and Equitable Tax Policy for America's Working Families

September 6, 2007

Mr. Chairman and Members of the Committee:

My name is Stephen Shay. I am a partner in the law firm Ropes & Gray in Boston. I specialize in U.S. international income taxation and was formerly an International Tax Counsel for the Department of the Treasury.[1] The views I am expressing are my personal views and do not represent the views of either my clients or my law firm.

With the Chairman's permission, I would like to submit my testimony for the record and summarize my principal observations in oral remarks.

The subject of today's hearing is a fair and equitable tax policy for America's working families. I will address the issue of fairness in the context of our international tax rules. I will direct my testimony and remarks toward the how fairness concerns may be taken into account in U.S. tax rules relating to the taxation of foreign business income, that is, income earned from conducting economic activity outside the United States.[2]

U.S. Tax Policy Objectives – The Role of Fairness

The principal function of the U.S. Federal income tax system is to collect revenue.[3] The manner in which the system serves this role is guided by traditional tax policy criteria of fairness, efficiency and administrability.[4] In applying these criteria, the correct measure of U.S. welfare is the well being of individual U.S. citizens and residents. Accordingly, the primary focus of U.S. income tax policy should be how to

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[1] I have attached a copy of my biography to this testimony.

[2] In June, 2006, I testified before the Subcommittee on Select Revenue Measures on the impact of international tax reform on U.S. competitiveness. I will draw on that testimony in my testimony today.

[3] Secondary roles of the U.S. income tax system include appropriating public funds, through "tax expenditures," and regulating behavior through tax penalties (which sometimes are sometimes referred to as negative tax expenditures). *See* Daniel N. Shaviro, "Rethinking Tax Expenditures and Fiscal Language," 57 TAX L. REV. 187 (2004); David A. Weisbach & Jacob Nussim, "The Integration of Tax And Spending Programs," 113 YALE L. J. 955, 961 (2004).

[4] U.S. TREAS. DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 13-19 (1984).

raise revenue in a manner that improves the lives and living standards of those individuals and fairly allocates the burden of the taxes imposed.[5]

The policy criteria of fairness, efficiency, and administrability conflict. Nonetheless, while there may be differences in opinion regarding the ideal tax base or rate structure to employ in taxing income, there is a broad consensus supporting application of fairness criteria to policy analysis of the income tax system. Indeed, fairness has been a principal justification for the income tax in the United States since its inception.[6]

The fairness criterion is based on the accepted notion that a fair tax should take account of taxpayers ability to pay. One of the reasons to base a tax on a taxpayer's entire income is that income is a reasonable proxy for "ability to pay." Relating the amount of tax to a person's income is considered to achieve fairness by relating the tax to the taxpayer's ability-to-pay.[7]

I will not in this testimony review the arguments regarding what neutrality principles should guide international tax policy.[8] There is a lack of consensus among economists regarding what neutrality principle should guide U.S. tax policy in an open economy setting.[9] Generally, the efficiency criterion supports rules that distort pre-tax economic decisions as little as possible. A common sense approach to efficiency would be to seek to reduce the tax incentives to shift economic activity in response to differences in, e.g., lower, effective tax rates.[10] In other words, from an overall U.S.

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[5] See Michael J. Graetz, "The David Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies," 54 Tax Law Rev. 261, 284 (2001) [hereinafter Graetz, Taxing International Income].

[6] There is a rich academic literature about the theoretically appropriate bases on which to evaluate fairness claims and even whether such claims have normative content. *See* J. Clifton Fleming, Robert J. Peroni & Stephen E. Shay, "Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income," 5 FLA. TAX REV. 299, 301 at note 12 (2001) [hereinafter Fleming, Peroni & Shay, Fairness in International Taxation]. It seems clear, however, that the perception that imposing tax on income tax is fundamentally fair has played an important role in the continued importance of the income tax as a means of raising revenue in the United States and other developed countries.

[7] I do not consider here issues relating to whether rates of tax on income should be progressive (i.e., increase with income) or flat. Nor do I consider how the distribution of tax burden should be analyzed, i.e., should it take account of governmental transfer payments to individuals and subsidies to businesses.

[8] See David L. Brumbaugh and Jane G. Gravelle, "Reform of U.S. International Taxation: Alternatives," CRS-4 – CRS-11 (CRS Report for Congress R.L. 34115) (July 31, 2007) [hereinafter Brumbaugh and Gravelle, Reform of International Taxation]; American Bar Association Tax Section Task Force on International Tax Reform, "Report of the Task Force on International Tax Reform," 59 TAX LAW. 649, 680 – 689 (2006) [hereinafter ABA Report].

[9] *See* ABA Report, *supra* note 8.

[10] The President's Advisory Panel on Federal Tax Reform articulated a standard for evaluating proposals that favor one activity over another that should be applied to evaluate proposals to tax foreign income more or less favorably than domestic income:

> Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special tax treatment *only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers*. (Emphasis added.)

perspective, the effective tax rate on an item of foreign income, taking into account foreign taxes, should not be materially lower than the effective rate on domestic income. A corollary is that relief should not be given to high foreign effective tax rates through cross-crediting.

The administrability criterion recognizes that the costs of administration and enforcement, to government and taxpayers, are not productive costs and should be kept to the minimum possible. While recognizing that taxpayers with international income are generally sophisticated and able to deal with complex provisions, a system whose complexity fosters wasteful tax planning and which is difficult to administer by tax authorities is undesirable.

The taxation of foreign business income presents particular fairness issues. Before reviewing those issues, I will briefly outline the U.S. rules for taxing U.S. persons' foreign business income.

Current U.S. Rules For Taxing International Income

Worldwide taxation subject to a limited tax credit for foreign income taxes. The United States taxes the worldwide income of U.S. citizens, resident aliens and domestic corporations. Generally, the United States allows a taxpayer to elect to credit foreign income taxes paid or deemed paid up to the amount of U.S. tax on foreign-source net income in the same limitation category.

U.S. source taxation of a foreign corporation. In contrast to the taxation of U.S. persons, foreign persons are taxed by the United States only on a source basis. Foreign persons that carry on a U.S. trade or business are taxed on their net income effectively connected with that trade or business. If resident in a treaty country, the foreign person's income must be attributable to a so-called "permanent establishment" in the United States. Foreign persons earning U.S. source income not connected with a U.S. trade or business are taxed on U.S.-source interest, dividends, royalties and other fixed or determinable, annual or periodical ("FDAP") income at a rate of 30% (or lower treaty rate) on the gross amount of the income. U.S. effectively connected earnings of a foreign corporation are subject to a second level branch profits tax.[11] A foreign corporation is not taxed by the United States on foreign income unless the foreign income is effectively connected with a U.S. trade or business.

U.S. shareholder taxation of income earned through a foreign corporation. Most active foreign business income earned by a U.S.-owned foreign corporation is not taxed

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PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR & PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM, REPORT OF THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM xiii (Nov. 2005), *available at* http://www.taxreformpanel.gov/final-report/ [hereinafter PRESIDENT'S ADVISORY PANEL REPORT].

[11] The determination of whether a corporation is domestic or foreign is essentially elective. A corporation is domestic if it is incorporated under the laws of the United States, one of the states of the United States or the District of Columbia or is a business entity that is otherwise organized under such laws and elects to be taxable as a corporation.

to its U.S. shareholders until distributed (this is referred to as "deferral"). The United States allows a U.S. corporate shareholder owning 10% or more by vote of a foreign corporation a credit for foreign income taxes associated with the foreign corporation's earnings that are distributed or deemed distributed to that shareholder.[12] This "indirect" or "deemed paid" credit mitigates double corporate taxation of the foreign dividend.[13] An individual U.S. taxpayer may treat certain dividends from publicly traded foreign corporations and foreign corporations qualifying for the benefits of a comprehensive income tax treaty with the United States as qualified dividend income ("QDI") eligible for the 15% tax rate (through 2010).

Anti-deferral rules. A series of so-called anti-deferral rules are intended to discourage use of foreign corporations as mechanisms to avoid U.S. tax on certain passive and other "base company" income. The two principal anti-deferral regimes today are the controlled foreign corporation rules and the passive foreign investment company rules.[14] The tax rules relating to a United States shareholders' share of income earned by a controlled foreign corporation, in addition to limiting deferral for passive income, also end deferral for certain active business income that is earned through use of "base companies" and is subject to an effective rate of foreign tax that is lower than the U.S. rate. The investment in U.S. property rules are designed to prevent earnings of a controlled foreign corporation that have not been taxed to a United States shareholder from being made available, directly or indirectly, to a United States shareholder.

A United States shareholder's gain on the sale of stock in a controlled foreign corporation generally will be treated as a dividend to the extent of the shareholder's share of the controlled foreign corporation's earnings. What was once considered a negative provision for taxpayers that recaptured the benefits of deferral, is in many cases favorable or neutral. The dividend income will carry foreign tax credits to a 10% corporate shareholder and may constitute qualified dividend income eligible for the 15% rate (until 2010) to an individual shareholder.

A U.S. shareholder in a passive foreign investment company (or PFIC), that is not also a United States shareholder in a controlled foreign corporation, is subject to the rough equivalent of current taxation of the foreign corporation's earnings (or appreciation in value) under one of several alternative taxing regimes. As currently designed, the PFIC rules are intended to cause taxable U.S. shareholders in foreign investment

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[12] Because the U.S. tax on foreign income earned by a foreign corporation is deferred until the earnings are repatriated, rules are required to associate the foreign taxes to the earnings that are repatriated, either as an actual dividend or as income inclusions under subpart F. In addition, to permit the foreign tax credit limitation to operate effectively, the limitation categories are applied on a look-through basis to income of a controlled foreign corporation and a non-controlled Section 902 corporation.

[13] A dividends received deduction is not allowed with respect to a dividend from a foreign corporation of earnings that were not effectively connected with a U.S. trade or business.

[14] A "controlled foreign corporation" is a foreign corporation that is more than 50% owned, by vote or value, directly or indirectly under constructive ownership rules, by United States shareholders. A "United States shareholder" is a U.S. person that owns 10% or more by vote, directly or indirect under constructive ownership rules, of the foreign corporation. A passive foreign investment company is a foreign corporation that has 75% or more passive income or 50% or more passive assets.

companies to elect to be taxed in a manner that is comparable to the tax that would be imposed on a shareholder in a U.S. mutual fund.

Transfer pricing. The Internal Revenue Service has broad authority to reallocate income, deduction or expense between commonly controlled taxpayers if they engage in transactions that do not satisfy the arm's length standard. Regulations under Section 482 prescribe the method for determining whether loans of money or transfers of tangible property, intangible property and services are within a range of arm's length prices. Generally, if an arm's length price determined under methods prescribed in the regulations falls within the inter-quartile range of arm's length prices as finally determined, no transfer pricing adjustment will be made.

Observations Regarding Current U.S. Rules for Taxing Foreign Income of U.S. Persons

As I have previously testified, the current U.S. rules, while complex, represent the best of all worlds for U.S. multinational taxpayers.[15] The current U.S. tax rules relating to foreign business activity are a hybrid between actually taxing worldwide income and taxing foreign income at a lower or even zero rate (i.e., exempting foreign income).

Taxpayers that earn high-tax foreign income can use excess foreign tax credits against other low-taxed foreign income. The effect of this cross-crediting is to provide an incentive to a taxpayer with excess foreign tax credits to earn low-taxed foreign income and to credit the foreign tax against U.S. tax on this income. This effectively shifts the burden of a foreign country's high taxes to the United States. Excess foreign tax credits even can be used to offset U.S. tax on income from export sales that is treated as foreign-source income for U.S. tax purposes (though this income generally would not be taxed by the source country).

Allowing U.S. taxation of active foreign business income earned through a foreign corporation to be deferred until repatriated as a dividend encourages investment in lower tax countries. If low-taxed foreign income is earned through a foreign corporation, instead of directly by a U.S. person, and the earnings are reinvested in a foreign business, the U.S. tax may be deferred. Over a long enough period, deferral can be quite valuable and even approach exemption. The 85 percent dividends received deduction of Section 965 effectively exempted from U.S. tax substantially all of the earnings repatriated under that relief provision.[16]

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[15] Statement of Stephen E. Shay, Subcommittee on Select Revenue Measures of the Ways and Means Committee, U.S. House of Representatives, Hearing on U.S. International Competitiveness (June 23, 2006) [hereinafter Shay, Testimony Before Subcommittee on Select Revenue Measures].

[16] Ostensibly, 15% of the repatriated earnings were subject to U.S. tax at up to 35% for an effective rate of 5.25% on the dividend. In many cases, the U.S. tax was eliminated by foreign tax credits so the earnings were effectively exempt from U.S. tax. While billed as an economic relief measure, the homeland dividend provision would be more accurately described as a partial amnesty from U.S. tax for low-taxed offshore profits. For a perceptive critique of the "farce" that homeland dividend relief represented, *see* Charles I. Kingson, "The Great American Jobs Act Caper," 58 Tax L. Rev. 327, 388 – 391 (2006) [hereinafter Kingson, Great American Jobs Act Caper].

The U.S. anti-deferral rules have been narrowed or interpreted narrowly in recent years.[17] Taken together with the adoption of elective entity classification and the inherent flexibility of transfer pricing, there is substantial scope for tax planning, often with low taxed countries, to reduce foreign taxes and accelerate utilization of remaining foreign taxes as credits.[18] If the United States allows unlimited deferral, it is reasonable to expect that use of low tax regimes will continue to increase.[19]

In practice, the current U.S. system of worldwide taxation with elective deferral of U.S. tax on foreign corporate business income, while complex, can be managed to achieve low effective rates of tax on foreign income. If U.S. multinationals earn income from active business operations carried on through foreign corporations in low-effective-tax rate structures, enhanced by transfer pricing planning, the U.S. multinationals generally pay no residual U.S. tax until they either receive dividends or sell their shares. When this effective tax reduction is combined with other features of the U.S. international tax regime (i.e., the ability to cross-credit excess foreign taxes against royalty income and export sales income), the overall effect can be more generous than an exemption system.[20] This is borne out by estimates that government tax revenues would *increase* if active foreign business earnings are exempt from U.S. tax when distributed as a dividend.

To summarize, our current international tax rules offer substantial planning opportunities to reduce foreign taxes and to shift income to entities with low-effective tax rates. The effect is to distort economic decisions and create incentives to structure business activity in a manner that takes advantage of low or reduced effective tax rates.

Fairness In Taxation of International Income

There is no *a priori* reason for excluding foreign income from the analysis of a person's ability to pay, whether the income is earned directly by individuals or indirectly

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[17] *See e.g.*, I.R.C. 954(c)(6) (expanding the ability to shift income from high to low taxed affiliates without triggering current income inclusion to a United States shareholder), Notice 2007-13, 2007-5 I.R.B. 410 (limiting the circumstances in which services performed by a controlled foreign corporation will be considered to benefit from assistance of a U.S. person and therefore be subject to current income inclusion to a United States shareholder).

[18] *See* Kingson, Great American Jobs Act Caper, *supra* note 16, at 370 – 387; ABA Report, *supra* note 8, at 705.

[19] *See e.g.*, Martin A. Sullivan, "Economic Analysis: the IRS Multibillion-Dollar Subsidy for Ireland," 108 Tax Notes 287 (July 18, 2005). Charles Kingson correctly observes that repealing the application of the PFIC rules to United States shareholders in a controlled foreign corporation in 1997 eliminated the only tax-based limit on the amount of controlled foreign corporation earnings that could be deferred by a member of the U.S. control group. Kingson, Great American Jobs Act Caper, *supra* note 16, at 382 – 385. U.S. shareholders with less than 10% holdings remains subject to the PFIC rules and the PFIC asset test in particular. It would have made more sense to repeal the PFIC asset test for U.S. portfolio investors and retain it as a limit on deferral for greater than 10% U.S. shareholders in a controlled foreign corporation.

[20] *See e.g.*, Harry Grubert and Rosanne Altshuler,"Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income,"9 – 10 (Draft of December 12, 2006), *available at* http://www-snde.rutgers.edu/scripts/Rutgers/wp/rutgers-listwp.exe?200626.

through foreign activities of U.S. or foreign corporations.[21] If U.S. taxation of foreign business income is lower than on domestic business income, U.S. persons who do not earn foreign business income will be subject to heavier taxation solely because of where their business is located. This would violate the ability-to-pay norm. To justify relief from U.S. tax on foreign business income, there should be an identifiable benefit to individual U.S. citizens and residents.

Allowing unlimited deferral of U.S. taxation on foreign business income is not consistent with the ability to pay criterion. The justification for the deferral benefit (which is another form of subsidy for foreign investment) is that it allows U.S. companies to compete on a level playing field with foreign and local competitors. In addition to concerns about fairness, however, there are numerous adverse consequences of deferral, including that it distorts investment decisions toward low taxed countries, it penalizes redeployment of low taxed foreign earnings in the United States, it requires complex rules to allow foreign tax credits for corporate shareholders, and it requires anti-deferral provisions to prevent its abuse that are difficult to administer and enforce.

Allowing a credit for foreign income taxes, or exempting active foreign business income, also is not consistent with the ability to pay criterion. Such relief from double taxation may be justified, however, by the expectation that the benefits of international trade resulting from the elimination of double taxation will accrue to individual U.S. citizens and residents. There are significant aspects of the U.S. foreign tax credit rules, however, that allow credits beyond what would be necessary to eliminate double taxation of foreign income and can not be justified other than as a subsidy for foreign investment. These include, as discussed below, source rules that expand the definition of foreign income to include income that is attributable to U.S. economic activity and is not taxed by foreign countries. In addition, expenses attributable to earning foreign income are allocated to U.S. income in ways that expand the foreign tax credit limitation to allow foreign taxes to offset U.S. tax on what properly should be U.S. net income.

There is little or no empirical evidence that the benefits of allowing deferral to U.S. companies or excessive credits for foreign taxes is efficient in that it generates more benefits to U.S. citizens and residents than it costs in higher taxes on U.S. citizens and residents and domestic businesses. If the reduced level of U.S. tax on corporate income allowed under current U.S. international tax rules shifts the tax burden to U.S. citizens and residents beyond what can be justified to avoid double taxation of income, the fairness criterion is not satisfied. If current rules are not fair, what can be done about it?

Possible Changes to Current U.S. Rules for Taxing Foreign Business Income to Increase Fairness

The major approaches by which the tax system of a country (the "residence country") taxes business income earned by its residents in a foreign country

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[21] *See* Fleming, Peroni & Shay, Fairness in International Taxation, *supra* note 6; *see also* Nancy H. Kaufman, "Fairness and the Taxation of International Income," 29 LAW & POLICY INT'L BUS. 145 (1998); Graetz, Taxing International Income, *supra* note 5.

("foreign-source income") are worldwide taxation subject to a credit for foreign taxes and exemption of foreign business income (also referred to as a territorial system).[22] The principal attractions of a foreign exemption proposal are that it would eliminate the tax on repatriation of earnings under a deferral regime and would foreclose relief for high foreign taxes through cross-crediting . It nevertheless leaves other problems of current law unsolved. Significantly, the incentive for income shifting activity to low-tax locations would increase.[23] I have previously testified why I do not believe that the benefits from an exemption system are likely to be superior on efficiency or fairness grounds to reforms based on current taxation of foreign business income with an appropriately limited foreign tax credit.[24]

I respectfully submit that reducing the scope for deferral and more closely aligning foreign tax credit rules to the purpose of avoiding double taxation should be supported on grounds of fairness and efficiency.

There are two basic approaches to taxing the income of a controlled foreign corporation currently in the hands of a U.S. shareholder. One approach would be to adopt pass-through treatment for earnings.[25] This would have the benefit of maintaining the character and source of the income and subjecting the income to the applicable tax rate of the shareholder. It would permit current pass-through of losses. While conduit taxation may be optimal as a theoretical matter, it would constitute a dramatic and difficult change from current law.

Current taxation of U.S. shareholders under an expansion of Subpart F, while second best to a conduit approach, would be a substantial improvement over current law

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[22] There have been a number of proposals to exempt foreign business income, including in the President's Advisory Panel on Federal Tax Reform's Simplified Income Tax Proposal. The President's Advisory Panel's exemption proposal would exempt a domestic corporation from tax on dividends from a foreign corporation attributable to certain active business income. PRESIDENT'S ADVISORY PANEL REPORT . *supra* note 10, at 124-25. The Joint Committee on Taxation Staff also has an exemption proposal that is more detailed than the President's proposal. STAFF OF JOINT COMM. ON TAX'N, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCS-02-05, 191 (Jan. 27, 2005).

[23] As noted by Edward Kleinbard, "*Territorial tax systems, by contrast, reward successful transfer pricing gamers as "instant winners"* by enabling the successful U.S. firm to recycle immediately its offshore profits as tax-exempt dividends paid to the U.S. parent." (Emphasis in original.) Edward D. Kleinbard, "Throw Territorial Taxation From the Train," 114 TAX NOTES 547, 554 (February 5, 2007) [hereinafter Kleinbard, Throw Territorial Taxation From the Train].

[24] Based on analyses that rest more on efficiency and administrability considerations, other commentators also express skepticism regarding territorial taxation proposals. *See* Kleinbard, Throw Territorial Taxation From the Train, *supra* note 23; Brumbaugh and Gravelle, Reform of International Taxation, *supra* note 8.

[25] I and my co-authors, Professors Robert J. Peroni and J. Clifton Fleming, Jr., have outlined a proposal for a broad repeal of deferral. Essentially, our proposal would apply mandatory pass-through treatment to 10% or greater shareholders in foreign corporations. Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It Instead of Expanding It*, 86 TAX NOTES 837 (2000).

and probably would enjoy broader support.[26] One approach would be to tax 10% or greater U.S. shareholders by vote in a controlled foreign corporation (more than 50% owned, by vote or value, directly or indirectly, under constructive ownership rules, by 10% U.S. shareholders by vote), to be currently taxed on their share of the controlled foreign corporation's income. There are a number of changes that should be considered to the specifics of these rules, but they have a history of use since 1962 and could be implemented without substantial re-design.[27]

A taxpayer's ability to control inter-company pricing is a fundamental attribute of international taxation. The necessary flexibility of tax rules affecting transfer pricing is a critical factor in assessing the structure of international tax rules. Indeed, I would submit that no approach to transfer pricing, including formula apportionment, will eliminate the potential for manipulation. Instead, the focus must be on reducing the effective tax rate differentials that drive transfer pricing planning. Reducing the scope for deferral is key to achieving this objective.

The current foreign tax credit mechanism should be improved by repeal of the sales source rule and other rationalization of source rules for taxing income from intangibles. Thus, for example, income from the licensing of intangibles should be sourced consistently with the sale of inventory (after repeal of the sales source rule) subject to an adjustment to allow a credit for foreign withholding tax, if any, on the royalty.[28] Current expense allocation rules permit the over-allocation of expenses to U.S. income, thereby expanding the foreign tax credit limitation. These rules should be reviewed and revised to limit their scope to what is appropriate to avoid double taxation. Other changes to limit cross-crediting of foreign taxes also should be considered.

The changes described above would move toward equalizing the taxation of foreign and domestic income. A base broadening approach that allowed for reduction in corporate tax rates generally would assist U.S. businesses that export from the United States or compete against foreign imports as well as businesses that operate abroad. The result would be a fairer tax system.

I would be pleased to answer any questions the Committee might have.

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[26] I acknowledge the substantial benefits of Edward Kleinbard's proposal for a more fundamental reform of business income generally. *See* Edward Kleinbard, "The Business Enterprise Income Tax: A Prospectus," 106 TAX NOTES 97 (Jan. 3, 2005). That proposal also is beyond the scope of this discussion.

[27] Less than 10% U.S. shareholders and 10% U.S. shareholders in foreign corporations that did not have a controlling U.S. shareholder group would be taxed under current law rules on distributions when received. The passive foreign investment company (PFIC) rules would continue to apply, however, the PFIC asset test should be eliminated for portfolio investors and the passive income threshold should be reduced to 50% from 75%. The PFIC taxing rules, a deferred tax with an interest charge, qualified electing fund pass-through taxation, or mark-to-market taxation, would apply to a U.S. shareholder in a PFIC.

[28] Approaches to these proposals may be found in ABA Report, *supra* note 8, at 772 – 774.

Stephen E. Shay
Ropes & Gray
One International Place
Boston, MA 02110-2624
(617) 951-7302 (direct dial)
(617) 951-7050 (facsimile)
sshay@ropesgray.com

Mr. Shay is not appearing on behalf of any client or organization.

Practice

Stephen E. Shay is a tax partner with Ropes & Gray in Boston, Massachusetts. Stephen has extensive experience in the international tax area, advising clients that include large and medium-sized multinational companies, financial institutions, and global investors on issues such as foreign tax credits, deferral of U.S. taxation, foreign currency gains and losses, withholding taxes and financial product issues. Stephen regularly advises clients on transfer pricing issues and has successfully resolved numerous transfer pricing controversies with the IRS. Stephen also works with Ropes & Gray's Private Client Group advising high net worth clients on cross-border income tax planning.

Stephen is a Lecturer in Law at the Harvard Law School teaching a course on international aspects of U.S. income taxation. Stephen was the Jacquin D. Bierman Visiting Lecturer in Taxation at Yale Law School in 2004. Stephen has served as Associate Reporter for the American Law Institute's Federal Income Tax Project on Income Tax Treaties with Reporters David R. Tillinghast and Professor Hugh Ault. He also is a Council Director of the American Bar Association Tax Section and has served as Chairman of the Tax Section's Committee on Foreign Activities of U.S. Taxpayers.

Before joining Ropes & Gray in 1987, Stephen was the International Tax Counsel for the United States Department of the Treasury. Prior to joining the Treasury Department as an Attorney Advisor in 1982, Stephen was associated with Reavis & McGrath and Coudert Brothers in New York City. Stephen received J.D. and M.B.A. degrees from Columbia University in 1976 and his B.A. from Wesleyan University in 1972.

Stephen has authored or co-authored numerous articles and has testified before Congress on international tax policy issues. Stephen's principal publications and testimony in the preceding 10 years are set out below.

Publications and Testimony

American Bar Association Tax Section, Task Force on International Tax Reform, "Report of the Task Force on International Tax Reform," 59 Lawyer 649 (2006) (principal draftsman)

Testimony , Subcommittee on Select Revenue Measures of the Ways and Means Committee, U.S. House of Representatives, Hearing on U.S. International Competitiveness (June 23, 2006)

Testimony, President's Advisory Panel on Federal Tax Reform, Panel on International Income Taxation (May 13, 2005)

"The David R. Tillinghast Lecture: 'What's Source Got to Do With It?' Source Rules and U.S. International Taxation," 56 Tax Law Rev. 81 (2003) (co-authored with Robert J. Peroni and J. Clifton Fleming Jr.)

Testimony, Finance Committee, United States Senate, Hearing on International Competitiveness (July 16, 2003)

"Reform and Simplification of the U.S. Foreign Tax Credit Rules," 31 Tax Notes Int'l 1145 (September 29, 2003) and 101 Tax Notes 103 (October 6, 2003) (co-authored with Robert J. Peroni and J. Clifton Fleming Jr.)

Testimony, Ways &Means Committee, U.S. House of Representatives, Hearing on WTO Extraterritorial Income Decision (February 28, 2002)

"Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income," 5 Fla. Tax Rev. 299 (2001) (co-authored with J. Clifton Fleming, Jr. and Robert J. Peroni)

"An Alternative View of Deferral: Considering a Proposal to Curtail, Not Expand, Deferral," 20 Tax Notes Int'l 547 (January 31, 2000) (co-authored with J. Clifton Fleming, Jr. and Robert J. Peroni)

"Deferral: Consider Ending It, Instead of Expanding It," 86 Tax Notes 837 (Feb. 7, 2000) (co-authored with J. Clifton Fleming, Jr. and Robert J. Peroni)

"Taking Territorial Taxation to Task," 20 Tax Notes Int'l 1178 (April 17, 2000) (co-authored with Robert J. Peroni and J. Clifton Fleming, Jr.)

"Qualified Intermediary Status, Act III: Rev. Proc. 2000-12's Final Qualified Intermediary Agreement and Amendments to Final Withholding Rules," 29 Tax Mgmt. Int'l J. 403 (July 14, 2000) (co-authored with Susan C. Morse and Christopher J. Peters)

"Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income," 52 SMU Law Review 455-530 (Spring 1999)
(co-authored Robert J. Peroni and J. Clifton Fleming, Jr.)

"Qualified Intermediary Status: A New Withholding Role for Foreign Financial Institutions Under Final U.S. Withholding Regulations," 27 Tax Mgmt Int'l J. 3 (1998) (co-authored with Susan C. Morse)

"Selected International Aspects of Tax Reform Proposals," 51 U. Miami L. Rev. 1029 (1997), reprinted in American Bar Association Section of Taxation, Tax Systems Tax Force, "A Comprehensive Analysis of Current Consumption Tax Proposals" (1997) (co-authored with Victoria P. Summers)

"Revisiting U.S. Anti-Deferral Rules," TAXES (December, 1996)

"Chapter 6, Taxation Policy," co-authored with Elinore J. Richardson, Esq., in Pritchard, ed., Economic Development, Foreign Investment and the Law: Issues of Private Sector Involvement Foreign Investment and the Rule of Law in a New Era, (Kluwer 1996)

Mr. NEAL. We thank the gentleman. Mr. Leon Metzger, former vice Chairman and chief administration officer of Paloma Partners Management Company, we welcome your testimony.

Mr. Metzger.

STATEMENT OF LEON M. METZGER, ADJUNCT FACULTY, COLUMBIA, NEW YORK, AND YALE UNIVERSITIES

Mr. METZGER. Mr. Chairman, Mr. Ranking Member, and distinguished Members of the Committee, I applaud your efforts to conduct a hearing on fairness and equity in the Internal Revenue Code. I am here to explain why some hedge funds are organized offshore. Investors in hedge funds can be classified as U.S. taxable, U.S. tax-exempt, and foreign. In a master feeder arrangement, the fund advisor manages only one pool of trading capital, the "master" fund, which is either an onshore or offshore limited partnership, or an offshore corporation that "checks the box" to be treated as a partnership for U.S. tax purposes. The master fund's capital is supplied by two or more feeder funds. Taxable investors invest in one "feeder" fund, a flow-through entity, while U.S. tax-exempt and foreign investors invest in the other one, an offshore corporation.

Usually, hedge funds compensate their advisers in two ways: a management fee, frequently 2 percent of capital under management, and incentive compensation, typically 20 percent of the profits. In my experience, most hedge fund income of U.S. taxable investors is taxed at ordinary rates because, one, funds tend to trade rapidly in and out of positions, which generate short-term capital gains or losses; two, all capital gains and losses deriving from short sales are treated as short-term; three, gains or losses from section 1256 regulated futures contracts, no matter how long the positions are open, are treated as 60 percent long-term and 40 percent short-term capital; and, fourth, many funds elect section 475 mark-to-market ordinary-income treatment.

Hedge fund advisers to offshore corporate feeder entities often defer their management fee and incentive compensation for periods as long as 10 years when they expect that the benefit of deferral will exceed the benefit of being taxed partially at preferential rates. Therefore, hedge fund advisers that can elect to defer their income instead of receiving a carried interest often do so.

How does deferral work? The offshore corporation accrues the compensation for the advisor but does not pay it. Each year, the notional value grows or contracts at the same rate as the performance of the fund. Assuming an adviser uses the cash method of accounting, the adviser does not record any taxable income until the compensation is paid.

Why do U.S. tax-exempt investors invest offshore? These investors would be subject to tax on their share of earnings from unrelated—if they invested in a flow-through entity. Typically, the income they receive when they redeem their shares is not considered unrelated debt—financed income because these blocker corporations prevent the debts from being attributed to tax-exempt investors. These offshore corporations are located in either no- or low-tax jurisdictions. In general, the only U.S. tax paid by these corporations is the U.S. withholding tax on dividends received. Often,

derivative financial instruments are used to avoid the dividend withholding tax.

There has been talk about possibly taxing U.S. tax-exempt investors on their indirect share of unrelated debt-financed income even if they invest through offshore corporations. If the purpose of such a law is to raise revenues to offset the elimination of the alternative minimum tax, it is worth noting that many of the beneficiaries of pension plans that invest in hedge funds are middle-class taxpayers. What they save in AMT, they might give back in reduced pension benefits, if such a law were enacted.

Foreign investors invest through offshore blocker corporations to maintain confidentiality and to avoid the U.S. regulatory environment applicable to U.S. taxable investors. These corporations also allow foreign investors to avoid direct liability from the fund's "effectively connected income," if any.

My written statement addresses other important issues. Thank you for inviting me to testify. I would be happy to answer any questions you may have.

[The prepared statement of Mr. Metzger follows:]

Prepared Statement of Leon M. Metzger, Former Vice Chairman and Chief Administration Officer of Paloma Partners Management Company

Mr. Chairman, Mr. Ranking Member, and Distinguished Members of the Committee:

I applaud your efforts to **conduct a hearing on fairness and equity in the Internal Revenue Code (Code)**. I am here to explain why some investment funds are organized offshore.[1]

Investors in hedge funds, which are private investment vehicles, can be classified as U.S. taxable; U.S.-tax-exempt; and foreign. Each has a different goal. For example, taxable investors prefer long-term capital gains (LTCGs) and qualified dividends to short-term capital gains and ordinary income, flow-through[2] status of their investment vehicles, and the flexibility to invest in certain derivative financial instruments that would minimize their current tax liabilities. U.S. tax-exempt investors might want to avoid investing in flow-through entities that generate unrelated debt-financed income (UDFI).[3] Foreign investors might want to avoid investing in an entity that generates income that is effectively connected with a U.S. trade or business. U.S. tax-exempt and foreign investors want the investment entity to minimize the amount of U.S. withholding taxes, and all three types want to avoid incurring costs that pay for a transaction that benefits the other type but not itself.[4]

Most hedge funds use one of two structures to satisfy the investors. In a side-by-side arrangement,[5] the fund adviser[6] manages two or more pools of trading capital,

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[1] By way of background, I teach hedge-fund management courses at Columbia, New York, and Yale Universities. An expert witness, arbitrator, and consultant on financial-services matters, I was associated with a hedge fund management company for 18 years, most recently as its vice chairman and chief administrative officer. My opinions do not necessarily reflect those of any institution with which I have been or currently am affiliated. I do not hold myself out to be a tax expert.

[2] Flow-through entities in this context either can be general or limited partnerships; limited liability companies (LLCs), which are treated as partnerships for tax purposes; S corporations; and certain trusts. For purposes of this discussion, when I use the term, "flow through," I am referring to either partnerships or LLCs.

[3] UDFI is considered unrelated business taxable income (UBTI) to otherwise tax-exempt investors.

[4] For example, a notional principal contract (e.g., swap) may achieve an inferior pre-tax economic result compared to a direct investment, but, post-tax, it may generate a superior result for taxable investors notwithstanding the financing cost involved. For an investor who does not pay taxes, the financing cost of the contract represents an economic cost without any offsetting gain.

[5] A side-by-side structure could look like this:

[6] For this testimony, the term, "adviser," includes advisers, LLC managers, and general partners.

one in the U.S. for taxable investors, and the others offshore for U.S.-tax-exempt and foreign investors, often by splitting tickets[7] between or among the pools.

In a master-feeder arrangement,[8] the fund adviser manages only one pool of trading capital, the "master" fund, which is either an onshore or offshore limited partnership, or an offshore corporation that "checks the box" to be treated as a partnership for U.S. tax purposes. The master fund's capital is supplied by two or more "feeder" funds. Taxable investors invest in one feeder fund, also a flow-through entity, while the U.S.-tax-exempt and foreign investors invest in the other one, an offshore corporation.

Usually, hedge funds compensate their advisers in two ways: a management fee, frequently 2 percent of capital under management; and incentive compensation, typically 20 percent of the realized profits, which is structured either as another fee, if paid by an offshore corporation, or as a special allocation of partnership profits, also known as a "carried interest," if paid by a flow-through entity. If the feeder is a flow-through entity, often the management fee and incentive compensation are paid to separate entities for state or local tax reasons. Usually, the offshore corporation pays just the adviser.

In the early days of master-feeder arrangements, the master funds were more often located onshore. More recently, the trend is for master funds to be located offshore.

In my experience, if one looks at the total pool of taxable income generated by all hedge funds, most of that income is not taxed at preferential rates. Reasons for this range from the fact that such funds tend to trade rapidly in and out of positions, which generates short-term capital gains and losses, to the rule that all capital gains and losses deriving from short sales, no matter how long the short sales are held open, are treated as short-term. Furthermore, gains or losses from section 1256 regulated futures contracts, no matter how long the positions are open, are treated as 60 percent long-term and 40 percent short-term capital. Last, many funds elect section 475 mark-to-market ordinary-income treatment. Hence, the preferential-rate income from the carried interest may be less than what many might have you believe.

Hedge fund advisers to offshore corporate-feeder entities often defer their management fee and incentive compensation for periods as long as ten years when they expect that the benefit of deferral will exceed the benefit of being taxed partially at preferential rates. For example, if a fund earns 10 percent pre-tax, of which 65 percent of its income is derived from preferential-rate income, the adviser will earn more, after tax, if he or she elects a ten-year deferral rather than accepting a carried interest. On the other hand, at a 20 percent pre-tax growth rate, almost 90 percent of a fund's income would need to be derived from preferential-rate income to make the manager prefer a carried interest to a ten-year deferral.[9]

How does the deferral work? The offshore corporation accrues the compensation to the adviser but does not pay it. Each year, the notional value grows or contracts, as the case may be, at the same rate as the performance of the fund. Assuming an adviser uses the cash method of accounting, the adviser does not include any income until it is paid. Advisers who opt for deferral take real economic risk because if the fund loses money, their eventual compensation will be reduced *pro rata*. Deferred compensation is subject to the claims of the general creditors of the offshore corporation.

Hedge fund advisers to onshore flow-through entities might also structure their management fee as a carried interest.[10] If the fund loses money and the management fee is paid in the form of a carried interest, however, the manager might need to borrow money to fund operations. Hence, these managers might take real economic risk to reduce their taxes. The incentive compensation in this case typically is an allocation of partnership profits.[11]

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[7] Splitting tickets is the process where the adviser enters one trade on behalf of two or more clients, and subsequently allocates the trade between or among those clients.

[8] A master-feeder structure could look like this:

[9] This table illustrates scenarios under a ten-year deferral:

[10] Fund Managers' Taxes May Rise as Senate Targets Fees Stratagem, By Ryan J. Donmoyer, *Bloomberg News*, June 19, 2007, http://www.bloomberg.com/apps/news?pid=20601070&refer=home&sid=aYdxW3YnhjK4

[11] In a U.S. corporation or partnership, there is a disincentive to deferral insofar as the employers will receive a current deduction if the compensation is paid currently. In a domestic situation, there is thus a tension between employees, who want to defer their compensation, and employers that wish to take a current deduction. When a hedge fund is formed with an offshore corporate feeder, there is no countervailing force working to ensure that the deduction is taken into account as soon as possible (unless it is a flow-through entity or a corporation that elects

Continued

Why do U.S.-tax-exempt investors invest offshore? These investors would be subject to tax on their share of earnings from UDFI if they invested in a flow-through entity. Typically, the income they receive from a corporation when they redeem their shares is not considered UDFI because the corporate "blockers" prevent the debt from being attributed to the tax-exempt investors. And, the offshore corporations are located in either no- or low-tax jurisdictions. In general, the only tax paid by these corporations is the U.S. withholding tax on dividends received. Often, the adviser is able to use derivative financial instruments to avoid the dividend withholding tax.[12]

While it may seem like an artificial device to allow a U.S.-tax-exempt investor to avoid UBTI simply by investing through a blocker corporation, it is questionable if UDFI from investments in hedge funds that trade securities[13] was ever the type of UBTI Congress had in mind when it enacted in 1950 and expanded the definition of UBTI in 1969 to cover abusive sale-leaseback transactions in which certain organizations rented their tax-exempt status for a fee.[14] Recently, there has been talk about possibly taxing the U.S.-tax-exempt investors on their indirect share of UDFI even if they invest through offshore corporations. If the purpose of such a law is to raise revenues to offset the elimination of the Alternative Minimum Tax, it is worth noting that many of the beneficiaries of pension plans, which invest in hedge funds, are middle-class taxpayers. What they save in AMT they may give back in reduced pension benefits.[15] While an overhaul of UDFI, section 514 of the Code, could lead to renewed abusive transactions, by allowing U.S.-tax-exempt investors to continue to rely on blocker corporations, Congress need not repeal section 514.

Foreign investors invest through offshore blocker corporations to maintain confidentiality and to avoid the U.S. regulatory environment applicable to U.S. taxable investors. The blocker corporation also allows foreign investors to avoid direct liability from the fund's "effectively connected income,"[16] if any.

If the master fund were an offshore corporation rather than a partnership, why might the adviser receive its compensation at the feeder-fund level rather than at the master-fund level? If deferral were so much better than receiving preferential-rate income, would it not make more sense if the master fund elected to defer the income? The answer is that because the master fund checks the box to be treated as a partnership, the investors in the U.S. feeder would not be entitled to a tax deduction for the adviser's deferred fees until they were paid, which would mean that their taxable income would exceed their economic income, which is usually an undesirable result.

Why might a master fund be domiciled offshore? First, the regulatory burden might be simpler there. Second, the administrative burden of withholding taxes is removed from the fund, which eliminates its risk of being subject to penalties for under withholding. Third, in certain jurisdictions, the fund may be able to achieve a higher degree of leverage than what U.S. regulators might allow. Last, there may be a sourcing (and thus withholding) benefit with regard to certain notional principal contracts.

Why might a master be domiciled onshore? First, the adviser might prefer to use Delaware law. Second, while the fund has the administrative burden of dealing with withholding taxes, it can hold, for a longer period, the cash that would otherwise be needed to be withheld, and earn income on such cash.

What are some of the advantages of the master-feeder arrangement compared to side-by-side funds? First, the adviser does not need to split tickets to generate similar returns between the funds. Second, if an investor withdraws from or contributes to a fund, the positions sold to meet the redemption or the asset purchased with the new funds will be spread *pro rata* among all investors, which enables the investors to earn similar returns, without requiring the adviser to re-balance the portfolios. Third, a larger pool of capital may ease credit terms, as there is more collateral.

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to check the box to be treated as a partnership for U.S. tax purposes). This lack of an incentive is one reason why hedge fund managers are able to defer their compensation for a significant portion of time.

[12] IRS Probes Tax Goal of Derivatives, by Anita Raghavan, *The Wall Street Journal*, July 19, 2007, page C1.

[13] Admittedly, the term, "hedge fund," is a self-designated moniker and certain of those funds engage in commercial activities that would not necessarily be considered trading in securities.

[14] Statement Regarding Unrelated Debt Financed Income and "Blocker Corporations," June 27, 2007, Council on Foundations, http://www.cof.org/files/Documents/Government/HedgeFundJune2007.pdf.

[15] I thank my NYU students, who called my attention to this point.

[16] In general, active business income other than trading in stocks, securities, and commodities.

What are some of the disadvantages of the master-feeder arrangement compared to side-by-side funds? First, the fund may lose the ability to invest in, say, a U.S. broker-dealer, which has customers, or a lending business because that might generate effectively connected income, which foreign investors want to avoid. Second, the adviser has the same fiduciary responsibility to all investors and cannot favor one class over another. Therefore, for example, the master may have to turn down the opportunity to invest in a derivative financial instrument that could convert ordinary income into LTCGs because the cost to finance such an investment would be borne by all investors, including those that do not stand to benefit from the tax savings. In such instances, a feeder fund might make an investment that another feeder cannot.

CONCLUDING COMMENTS

In this section, I will address other issues.

Carried interest is not a recently discovered nefarious tax loophole. Advisers to hedge funds and other industries have used it for many years.

I do not believe that hedge-fund and private-equity advisers should be subject to one set of tax rules, while others, who provide similar services, are subject to different rules, whether more lenient or strict. Singling out specific industries for special adverse tax legislation by enacting, e.g., a "hedge-fund adviser's windfall profits tax" would be poor public policy. I agree with H.R. 2834, in this respect, that a carried interest is no different whether the investment vehicle holds real estate, oil and gas, venture capital, or stocks, bonds, and derivative financial instruments.

Some have argued that if all carried interest were taxed at ordinary rates, it might lead to fund managers' increasing their compensation beyond the typical "2 and 20" arrangement, which would reduce the returns of investors like pension plans and endowments. There is no requirement for advisers to charge "2 and 20." Indeed, it has been reported that one can find managers who charge "3 and 50," "5 and 44," and "4 and 23." And, some charge less than "2 and 20." The adviser's compensation typically is determined by the market. Advisers that have exceptional performance records or that have convinced investors that the prospects of exceptional performance are excellent, may try to charge more than "2 and 20." In contrast, advisers that have less-stellar performance records will encounter resistance from investors if they try to charge higher fees. Fees will increase if advisers try to raise them and the investors acquiesce.

If Congress decides to tax all income from carried interests as ordinary, some funds might try to replace a "2 and 20" structure with some variation of a higher management fee and partially non-recourse loan from the investors economically similar to a 20 percent carried interest. Effectively, the adviser would retain economics and tax consequences similar to the 20 percent carried interest on the positive side, but now would be exposed to any negative performance[17] and would incur interest expense, which might be offset by the higher management fee. If the economics for investors were potentially impaired by this type of arrangement, such deal could be implemented only if investment demand for those funds were relatively inelastic.

Does the U.S. economy truly benefit from preferential-income rates[18] and is "realization," rather than change in market value, the appropriate aspect for determining when income should be taxable to certain persons? If we retain the *status quo*, taxpayers will continue to arrange their affairs so that they can achieve the best character, timing, and source.

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[17] Should, for example, the fund implode, the adviser might have cancellation-of-indebtedness (COD) income from the loan and capital loss from the decline of its share of the fund, which would not necessarily offset because of the difference in character between those types of income. On the other hand, if, because of such an implosion, the adviser becomes insolvent, section 108 of the Code may exclude the COD income while simultaneously reducing the basis of the adviser's interest in the fund.

[18] Market liquidity and price discovery might not change significantly if preferential rates were eliminated. Paul Krugman, an economic professor at Princeton University, says, "[There's] very little evidence that taxing capital gains as ordinary income would actually hurt the economy." *The New York Times*, July 13, 2007, page A19. The majority of trades that are executed on the New York Stock Exchange are on behalf of public institutional investors, which do not benefit from preferential rates (see, e.g., http://www.calstrs.com/Investments/NYSEBoard112003.pdf). Alan S. Blinder, an economics professor at Princeton University and former vice chairman of the Federal Reserve, says, "[The] evidence—[that lower taxes on capital gains boost investment] is iffy at best, and there are better ways to spur investment, like, say, the investment tax credit." He adds, "The tax preference for capital gains undermines capitalism—a system in which capitalists, not the state, are supposed to make the investment decisions." *The New York Times*, Sunday Business, July 29, 2007, page 4.

Thank you for inviting me to share my views with you. I would be happy to answer any questions you may have.

This analysis does not consider the effect of any state and local taxes, e.g. New York City's Unincorporated Business Tax, which would make a deferral less desirable, as would a shorter period.

Mr. NEAL. Thank you, Mr. Metzger. Janne Gallagher, who is vice president and general counsel of the Council on Foundations, we welcome your testimony.

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STATEMENT OF JANNE G. GALLAGHER, VICE PRESIDENT AND GENERAL COUNSEL, COUNCIL ON FOUNDATIONS

Ms. GALLAGHER. Thank you. I want to acknowledge Professor Schmalbeck's assistance in helping us puzzle through these complicated issues.

The Council on Foundations is a membership organization of grant-making institutions. Our mission is promoting and enhancing responsible and effective philanthropy worldwide. My statement today could be summarized in two simple points: First, foundations seek diversified investment portfolios in order to maximize their ability to serve the common good. Second, we encourage any legislation that will remove the barriers to direct investment by foundations in U.S. hedge funds.

Before offering some background on why many foundation investments and hedge funds are in corporate entities located outside the United States, let me stress that the Council on Foundations does not advocate the use of offshore blockers nor do we have a position on whether Congress should restrict such use.

Foundations investing through offshore blockers are sophisticated investors. They include hedge funds among their investments to diversify their portfolios, improve their yields and enhance the preservation of their capital in down markets. Based on surveys of our members, hedge funds were a small but significant portion of investment portfolios, averaging about 8.4 percent for private foundations and about 7.5 percent for community foundations.

Foundations invest in hedge funds to produce a stream of revenue that provides support to communities in the United States and around the world. I do not know of any foundation that wants to invest in offshore blocker corporations. The current law is such that foundations that elect to invest in hedge funds would not be prudent stewards of their assets if they did not use these corporations to block the application of a tax that we believe Congress never intended to apply to this form of investment.

We believe Congress should consider changing current law to permit foundations to invest directly in U.S. hedge funds without incurring adverse tax consequences. If the section 514 debt-financed property rules did not apply to hedge fund investments, tax-exempts would be able to invest directly in U.S. hedge funds and the use of offshore blockers would end.

We believe these changes can be accomplished without creating new opportunities for abuse, and your next witness has some recommendations in that regard.

Foundations that invest in offshore blocker corporations do so in order to avoid exposure to unrelated debt-financed income tax liabilities under section 514. Most hedge funds make use of borrowed funds in some of their investment strategies but because they are generally organized as limited partnerships, the flow through characteristics of the partnership entity results in any debt incurred by the hedge funds being imputed to their charitable organization investors.

To address this problem, hedge funds have created foreign corporations in low tax jurisdictions and under a series of private letter rulings from the Internal Revenue Service, the dividends those corporations distribute to their charitable shareholders are free of any debt-financed taint.

Congress enacted the debt-financed property rules primarily to prevent transactions that use the charitable organization to convert ordinary business income into gains that could be taxed at lower rates as capital or quasi-capital gains. Unfortunately, section 514 does not distinguish between legitimate and illegitimate uses of debt. Further, debt today plays a much more important role in investment portfolios than it did back in 1969.

Finally, a number of post-1969 changes to the tax law generally make the transactions at which section 514 was aimed uneconomical or pointless, most significantly, the fact that corporations no longer enjoy a rate preference on their capital gain income.

In closing, we urge Congress to review the continued needs of the debt-financed property rules in light of other changes to the Tax Code and the distorting effect those rules have on investments by tax-exempt organizations. A further reason to look at section 514 is to address the disparity in the current exemption that is afforded to pension funds and universities but not to other charitable organizations if they invest in debt-financed real property. There is no apparent policy reason for this distinction, as joint Committee explanation notes, and we believe that section 514 without an exemption for other kinds of charitable entities unfairly disadvantages efforts by foundations to manage and diversify their portfolios through the inclusion of investments in real property. We ask that you consider making that exception available to all charitable organizations. Thank you very much.

[The prepared statement of Ms. Gallagher follows:]

Prepared Statement of Janne G. Gallagher,
Vice President and General Counsel, Council on Foundations

Thank you. Accompanying me is Richard Schmalbeck, Professor of Law, Duke University. Professor Schmalbeck is the primary author of the Council's June 27 White Paper, "Statement on Unrelated Business Income and Blocker Corporations.' We have submitted a copy of the paper as part of the record of this hearing.

The Council on Foundations (COF) is a membership organization of more than 2,000 grantmaking foundations and giving programs worldwide. For more than 55 years, the Council has served the public good by promoting and enhancing responsible and effective philanthropy. My statement today could be summarized in two simple points:

- Foundations seek a diversified investment portfolio to enhance their returns and their ability to serve the common good.

- We encourage any legislation that will remove the barriers to direct investment by foundations in U.S. hedge funds.

Let me provide some background on why many foundation investments in hedge funds are in corporate entities located outside the United States. But, I want to stress at the outset that the Council on Foundations does not advocate the use of offshore blockers, as these entities are commonly called, nor do we have a position on whether Congress should restrict such use.

Foundations investing through offshore blockers are sophisticated investors that include hedge funds in their investment portfolios to diversify their portfolios, improve their yields and enhance the preservation of their capital in down markets. They invest in hedge funds as part of an overall investment strategy that is designed to produce a stream of revenue that provides support to communities in the United States and around the world. I don't know of any foundation that wants to invest in offshore blocker corporations, but current law is such that foundations that elect to invest in hedge funds would not be prudent stewards of their assets if they did not use these corporations to block the application of a tax that we believe Congress never intended to apply to this form of investment. The Council believes the solution is to change current law to permit foundations to invest directly in U.S. hedge funds without incurring adverse tax consequences. If the section 514 debt-financed property rules did not apply to hedge fund investments, tax-exempts would be able to invest directly in U.S. hedge funds and the use of offshore blockers would end. We believe these changes can be accomplished without creating new opportunities for abuse.

Many tax-exempt organizations, including universities, foundations, and pension funds, include hedge funds in their investment portfolios. According to Council surveys, community foundations invested an average 7.5 percent of assets in hedge funds in 2006, while private foundations allocated 8.4 percent to hedge funds in 2005. From an investment viewpoint, these strategies have been successful, producing returns that have generally exceeded overall market performance measures in both rising and falling markets. They are not, of course, without risk, as recent events have demonstrated, and the Council has taken steps to educate our members about factors to consider in making investments in hedge funds. For example, our just-published report, *2006 Investment Performance and Practices of Community Foundations*, includes a five-page article, "The Dimensions of Investment Risk—Hedge Funds and Non-Market Risk," by a highly-respected investment consultant.

Tax-exempt organizations face a problem, however, in structuring their investments in hedge funds in ways that do not create exposure to unrelated debt-financed income tax liabilities under section 514 of the Internal Revenue Code. Hedge funds make use of borrowed funds in some of their investment strategies, especially those involving arbitrage. Because hedge funds are usually organized as limited partnerships, rather than as corporations, that borrowing is imputed to their partners, including any charitable organizations that may be limited partners. If a hedge fund were organized as a corporation, it could freely use debt in pursuit of its investment strategies, and still pay dividends to charitable stockholders that would not be characterized as unrelated debt-financed income. However, operating through a corporate structure would generate income tax liabilities at the entity level that are otherwise completely avoidable and that would be unacceptable to the fund's non-exempt investors.

To address this problem, hedge funds have created foreign corporations in low-tax jurisdictions. These corporations, in turn, invest in limited partnership hedge funds—typically in funds organized and operated within the U.S. The foreign corporations under these arrangements pay little corporate income tax in the countries in which they are incorporated (because of the very low rate structures generally prevailing in those countries). However under a series of private letter rulings from the Internal Revenue Service, the dividends they distribute to their charitable shareholders are free of any debt-financed income taint.

Congress enacted the debt-financed property rules primarily to prevent transactions that used a charitable organization to convert ordinary business income into gains that could be taxed at lower rates as capital (or quasi-capital) gains. Unfortunately, section 514 does not distinguish the legitimate use of debt from sham transactions. Investment portfolios maintained by taxable individuals and entities often make judicious use of debt to enhance returns in ways that cannot be described as abusive of any tax rules and which does not present the abuse section 514 was designed to prevent. Further, a number of post-1969 changes to the tax law that have nothing to do with charitable organizations would generally make the transactions at which section 514 was aimed either uneconomic or pointless today. The most significant among these is the fact that corporations no longer enjoy rate preferences

on capital gain income, which obviates any attempt to convert ordinary business income into capital gain in most cases. There may be a few special circumstances to which the unrelated debt-financed property rules should still apply, but hedge fund investments are not among them.

The primary purposes of the unrelated business income tax, and of the debt-financed property rules, are to protect the integrity of the corporate income tax, and to preserve a level playing field in cases where nonprofit organizations and profit-seeking firms compete. However, in cases where a nonprofit organization merely makes an investment, but does not actively conduct a business, Congress has provided exemption for the passive investment income received by the organization from the unrelated business income tax. This exemption extends both to income that was subject to tax at the corporate level (dividends), but also to income (rents, royalties, capital gains) upon which no corporate tax was paid. The income of hedge funds is not ordinarily exposed to corporate-level taxation, due to the widely accepted structuring of such funds as limited partnerships. Individual investors in such funds are and should be liable for taxes on the income of the funds; but since charitable entities are normally not liable for taxes on income from their investments, they should not be taxed on investment income generated by hedge funds. The use of blocker corporations effectively achieves this result, but the use of blockers would not be necessary if the tax were not construed as applying to theses investments.

The issue of the use of offshore blocker corporations in hedge fund investments illustrates the need for Congress to review the continued need for the debt-financed property rules in light of other changes to the Tax Code and the distorting effect of the rules on investments by tax-exempt organizations. An additional reason for undertaking such a review is to address the disparity in the current exemption for investments in debt-financed real property, which excludes only investments made by universities and by pension plans and not those by other tax-exempt organizations including foundations. There is no apparent policy reason for this distinction, which unfairly disadvantages efforts by foundations to manage and diversify their portfolios through the inclusion of investments in real property. We ask you also to consider making this exemption available to all charitable organizations if you undertake a reform of section 514.

Mr. NEAL. Thank you, Ms. Gallagher.

Suzanne Ross McDowell is a partner at Steptoe & Johnson. Ms. McDowell, we welcome your testimony.

STATEMENT OF SUZANNE ROSS MCDOWELL, PARTNER, STEPTOE & JOHNSON, LLP

Ms. MCDOWELL. Thank you. Mr. Chairman, Ranking Member Mr. McCrery and Members of the Committee, thank you for inviting me to appear today. My practice focuses on the law of tax-exempt organizations. In the eighties, I served in the Office of Tax Policy at the Treasury Department where I was responsible for issues relating to tax-exempt organizations, including issues relating to debt-financed income property. Since leaving Treasury, I have written papers and given presentations on the debt-financed income rules. My testimony will focus on these rules. It represents my views, not those of my firm, any client, or any other organization.

Let me begin with a brief overview of current law. For over 50 years, congressional policy has been to exclude most types of investment income from the unrelated business income tax. However, if the investment income is derived from property that was acquired with debt, the income is taxed under the debt-financed income rules. Thus, the debt-financed income rules are an exception to the general congressional policy of exempting investment income of tax-exempt organization from tax.

The original purpose of the debt-financed income rules, however, was not so broad. Rather, when enacted in 1969, these rules were

intended to foreclose abusive sale leaseback transactions. These transactions permitted businesses to sell property to tax-exempt organizations in transactions that converted ordinary income to capital gains and allowed the tax-exempt purchasers to buy the property over time while investing little or none of their own capital. No one suggests that it was not a good idea to put an end to such transactions.

The unrelated debt-financed income rules can be avoided on securities and financial products by investing through foreign corporations referred to as "blocker entities," as Mr. Metzger described.

At first blush, blocker entities may look like a loophole that should be shut down. However, blocker entities are frequently used to avoid the application of unrelated debt-financed income rules to legitimate, non-abusive transactions that were not the intended target of the rules. Thus, before taking action on blocker entities, it makes sense to take a look at the policy and impact of the unrelated debt-financed income rules.

These rules tax all debt-financed investments of tax-exempt organizations even though they were enacted for the narrower purpose of foreclosing abusive sale leaseback transactions. The current breadth of application of these rules would be justified only if all leveraged investments of tax-exempt investors should be discouraged. The purpose of leverage is to increase the investor's return on investments. The tradeoff for the increased return is taking on greater risk. The increased risk of an individual investment, however, can be reduced through diversification in the investor's portfolio. Furthermore, investments that do not use debt or leverage may be as risky or riskier than leveraged investments. Thus, taxing all debt-financed income is not an effective way to protect tax-exempt investors from risks if, indeed, that is the purpose. Moreover, the level of risk permissible for tax-exempt organizations is already addressed by various other laws at both the Federal and state level. These laws, which are explained in more detail in my written statement, permit the prudent use of debt financing.

As more fully described in my written statement, an additional problem with the debt-financed income rules is that they have been applied in a rigid manner that makes formalistic distinctions between debt and leverage. The result is that the rules tax transactions which involve straightforward borrowing in the traditional sense while permitting investors who use leverage in more sophisticated transactions to escape tax.

Finally, blocker entities are not the only way to avoid the debt-financed income rules. These rules can also be avoided by investing in mutual funds or REITs and through certain contractual arrangements.

I urge the Committee to significantly restrict the application of the debt-financed income rules. Under current law, there is an exception for real estate transactions if the transactions meet certain requirements which are designed or intended to prevent abuse. The exception is currently available only to pension funds and universities. This exception and its requirements should be used as the model for a broader exception to the debt-financed income rules applicable to all types of debt-financed property and available to all

tax-exempt organizations. My written testimony expands on this suggestion.

If Congress amends the unrelated debt-financed income rules as suggested, tax-exempt investors would no longer be forced to invest offshore and use blocker entities to avoid unrelated debt-financed income rules on legitimate investments. Further, the current disparate treatment between direct borrowing and leverage and between different types of tax-exempt investors would be eliminated.

Thank you again, and I would be pleased to answer any questions you may have.

[The prepared statement of Ms. McDowell follows:]

Prepared Statement of Suzanne Ross McDowell, Partner, Steptoe & Johnson LLP

Mr. Chairman and Members of the Committee:

My name is Suzanne Ross McDowell. I am a partner in the law firm Steptoe & Johnson llp in Washington, D.C. My practice focuses on the law of tax-exempt organizations with particular emphasis on tax, corporate governance, and commercial transactions. From 1983 to 1987, I served in the Office of Tax Policy at the U.S. Department of Treasury and was responsible for issues relating to tax-exempt organizations, including issues related to the debt-financed income rules. Since leaving the Treasury Department, I have written academic papers and given presentations on the debt-financed income rules and numerous other topics relevant to tax-exempt organizations.[1]

My testimony today will focus specifically on the unrelated debt-financed income rules. These rules impose a tax on investment income of an exempt organization that would otherwise be tax-exempt solely because the exempt organization uses debt to acquire the property that produces the income.[2] To avoid the tax imposed by the debt-financed income rules, exempt organizations often use so-called blocker entities to acquire investments. Generally speaking, a blocker entity is a corporate entity formed in a low-tax jurisdiction that is interposed between an investment and the exempt organization. The corporation "blocks" the attribution of any debt to the exempt organization, and thus enables the exempt organization to avoid the application of the debt-financed income rules. My testimony will cover the history and purpose of the rules, the types of transactions they discourage, and the policy concerns that should be considered by Congress in the course of its evaluation.

Legislative History and Current Law

Tax-Exempt Status of "Passive Income." Since 1950, tax-exempt organizations have been subject to the unrelated business income tax ("UBIT") on income from businesses that are not related to their exempt functions. When Congress enacted the UBIT, it excluded certain types of investment income—commonly referred to as "passive income"—from the tax. Specifically, dividends, interest, royalties, annuities, most rents, and capital gains and losses were not subject to UBIT.[3] In the years since the enactment of the UBIT, exceptions have been added for payments with respect to securities loans,[4] loan commitment fees,[5] and income from the lapse or termination of options.[6] According to the legislative history, Congress excluded these types of income from UBIT because it did not think they posed serious competition for taxable businesses and because such income had long been recognized as a proper source of revenue for educational and charitable organizations.[7]

Unrelated Debt-Financed Income Rules. The exclusion for "passive income" does not apply to the extent that such income is derived from debt-financed prop-

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[1] *Taxing Leverage Investments of Charitable Organizations: What is the Rationale?,* 39 Case W. Res. L. Rev. 705 (1988); *Taxation of Unrelated Debt-Financed Income*, 34 Exempt Org. Tax Rev. 197 (2001).

[2] IRC § 512(b)(4); 514(a)(1).

[3] IRC §§ 512(b)(1), (2), (3), (5).

[4] IRC § 512(b)(1), (a)(5).

[5] IRC § 512(b)(1).

[6] IRC § 512(b)(5).

[7] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38–40 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 30–31, (1950).

erty.[8] In other words, income earned by an exempt organization from debt-financed property is subject to tax. Property is treated as debt-financed if indebtedness is incurred before or after the acquisition or improvement of the property that would not have been incurred but for such acquisition or improvement.[9] The portion of income that is subject to tax is the fraction equal to the average acquisition indebtedness for the year over the average adjusted basis of the property for the year.[10]

The debt-financed income rules were passed in 1969 to foreclose abusive sale-leaseback transactions. In such transactions, a charitable organization would acquire property (usually real estate) from a taxable business, often borrowing to finance the entire purchase price. As a condition of the sale, the exempt organization would lease the property back to the seller on a long-term basis. The exempt organization would repay the loan, plus interest, with the lease payments or "rental payments" received from the seller-lessee. The exempt organization would receive both (i) the difference between the "rental payments" and the sale price and (ii) outright title to the property, all without investing or risking much, if any, of its own funds. The seller would obtain capital gain treatment for the sale price received and large deductions against taxable income for the "rental payments" made, all while continuing to operate its business using the property in the same manner as before.[11]

Application of Unrelated Debt-Financed Income Rules to Securities and Financial Products. The debt-financed income rules have been challenging to apply to securities and other financial products. Neither the Internal Revenue Code (the "Code") nor the Treasury regulations thereunder define "indebtedness" for purposes of the debt-financed income rules. Consequently, in determining whether a particular transaction creates indebtedness and therefore is subject to tax, the Internal Revenue Service and the courts have looked to common law definitions of indebtedness and definitions in other parts of the Code. The result has been that the rules have been applied in a formalistic manner. Generally, when a tax-exempt investor borrows funds and has a clear obligation to repay the funds, the debt-financed income rules have been applied. Thus, securities purchased on margin have been held to be debt-financed property.[12] A pension plan that used a certificate of deposit ("CD") with a low interest rate as collateral to borrow funds to acquire a new CD with a higher interest rate, was subject to UBIT on the new CD because it was purchased with borrowed funds.[13] In this case, the pension fund was not seeking to leverage its investment. Rather, it didn't want to redeem the low-interest CD before its maturity date because it would have incurred penalties, but it wanted to reap the benefits of an increase in interest rates. Similarly, the withdrawal of the accumulated cash value of life insurance policies for the purpose of investing the funds in property with a higher rate of return creates acquisition indebtedness and therefore is unrelated debt-financed income when such withdrawals are used to purchase securities.[14]

In contrast to the above examples, many transactions that do not involve debt in the traditional sense but do involve leverage are not subject to the debt-financed property rules. In many cases, because the transactions were not clear cases of borrowing, the IRS relied on Congressional intent to exclude investment income from tax in reaching its conclusion that the debt-financed income rules do not apply. Thus, securities lending transactions,[15] short sales of stock,[16] commodities futures contracts,[17] securities arbitrage transactions[18] and notional principal contracts[19] are not treated as debt-financed property and are not subject to UBIT.

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[8] Section 514 applies to all debt-financed property but contains several exceptions which have the collective effect of generally limiting its application to investment income.

[9] IRC § 514(c)(1).

[10] IRC § 514(a)(1).

[11] S. Rep. No. 552, 91st Cong., 1st Sess. 62–63, *reprinted in* 1969 U.S.C.C.A.N. 2027, 2091–92; H.R. Rep. No. 413, 91st Cong., 1st Sess. 44–46, *reprinted in* 1969 U.S.C.C.A.N. 1645, 1690–91.

[12] *See, e.g.*, *Elliott Knitwear Profit Sharing Plan v. Comm'r*, 614 F.2d 347 (3d Cir. 1980), *Alabama Central Credit Union v. United States*, 646 F. Supp. 1199 (N.D. Ala. 1986); *Ocean Cove Corporation Retirement Plan v. United States*, 657 F. Supp. 776 (S.D. Fla. 1987); *Henry E. & Nancy Horton Bartels Trust for the Benefit of the University of New Haven v. United States*, 209 F.3d 147, 156 (2d Cir. 2000).

[13] *See Kern County Electrical Pension Fund v. Comm'r*, 96 T.C. 845 (1991).

[14] *Mose & Garrison Siskind Memorial Foundation Foundation v. United States*, 790 F.2d 480 (6th Cir. 1986).

[15] Rev. Rul. 78–88, 1978–1 CB 163.

[16] Rev. Rul. 95–8, 1995–1 CB 107. *See also* PLR 9637053 (Sept. 13, 1996); PLR 9703027 (Jan. 17, 1997).

[17] Gen. Couns. Mem. 39620 (April 3, 1987).

[18] Gen. Couns. Mem. 39615 (March 23, 1987).

Limited Exception for Real Estate. Income earned from real estate is excluded from the unrelated debt-financed income rules under a limited exception, but only if certain conditions are satisfied. [20] Additionally, the exception only applies to real property acquired by pension trusts, schools, colleges and universities. To qualify for the exception, the real estate transaction must not have certain characteristics of the sale-leaseback transactions that were the target of the rules when first enacted. Thus, for example, the transaction cannot involve (i) seller financing; (ii) indebtedness determined by reference to income from the property; or (iii) a lease back to the seller.[21] Additionally, in the case of real estate investments made by partnerships, the exception is limited to transactions that do not permit tax-exempt partners to transfer tax benefits to taxable partners.[22] Certain of these rules that limit the exception for real estate partnerships, most notably the so-called "Fractions Rule," are exceedingly complex and difficult to apply in practice.[23]

"Blocker Entities." The unrelated debt-financed income rules can be avoided on securities and financial products by investing through foreign corporations referred to as "blocker entities." A blocker entity is a foreign corporation usually established in a low tax jurisdiction. The tax-exempt investor invests in the foreign corporation and the foreign corporation in turn invests in a hedge fund or other similar debt-financed investment. Income from the hedge fund or other investment is distributed to the foreign corporation, which pays little or no tax on the income as a result of the jurisdiction in which it is established. The foreign corporation in turn pays the income to the tax-exempt investor as a dividend. Because dividends are not subject to UBIT, the income from the hedge fund is not taxable to the tax-exempt investor and the debt-financed income rules are avoided. Most hedge funds are partnerships and, in the absence of the blocker entity, debt-financed income would be passed through to the tax-exempt investor as debt-financed income and would be subject to tax.[24] The Service has issued private letter rulings upholding the treatment of income received from a foreign corporation used as a blocker entity as a dividend that is not subject to UBIT.[25]

Discussion

At first blush, blocker entities may appear to be a "loophole" that should be shut down. However, blocker entities are frequently used to avoid the application of the unrelated debt-financed income rules to transactions that were never intended to be within the scope of the rules. Thus, before taking action on blocker entities, Congress should re-evaluate the policy and impact of the unrelated debt-financed income rules.[26]

The unrelated debt-financed property rules tax all debt-financed investments of tax-exempt organizations, although they were enacted to foreclose abusive sale leaseback transactions. The current breadth of application is justified only if all leveraged investments of tax-exempt investors should be discouraged. The purpose of leverage is to increase the investor's return on investment. The trade-off for the increased return is taking on greater risk.[27] The increased risk of an individual investment, however, can be reduced through diversification in the investor's portfolio. Furthermore, investments that do not use leverage may be as risky or riskier than leveraged investments. Thus, taxing all debt-financed income is not an effective way to protect tax-exempt investors from risk.

Moreover, the level of risk assumed by tax-exempt organizations is already addressed by various other laws that create legal standards for permissible investments of tax-exempt organizations. At the Federal level, investments of private foundations are subject to the jeopardizing investment rules of Code section 4944 and pension funds are subject to the fiduciary standards of ERISA.[28] At the state

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[19] Treas. Reg. § 1.512(b)-1(a)(1).
[20] IRC § 514(c)(9).
[21] IRC § 514(c)(9)(B)(i)-(v).
[22] IRC § 514(c)(9)(B)(i)-(v).
[23] IRC § 514(c)(9)(E).
[24] IRC § 512(c).
[25] Priv. Ltr. Rul. 199952086 (Sept. 30, 1999).
[26] In the 1980s, blocker entities were used to avoid UBIT on offshore captive insurance companies. *See* Priv. Ltr. Rul. 8819034 (Feb. 10, 1988). In response, Congress added Section 512(b)(17)(A) to the Code, providing that foreign source income from offshore captive insurance companies is taxable. Small Business Job Protection Act of 1996, Pub. L. 104–188, section 1603(a). Those cases, however, involved the operation of an active unrelated business—an activity that the UBIT is clearly intended to tax.
[27] For example, if an investor buys $100,000 worth of stock and the value of the stock increases by 10 percent in one year, the investor has earned $10,000. If this same investor bor-

level, directors of nonprofit corporations must adhere to the common law duties of care and loyalty. Additionally, most states have adopted the Uniform Management of Institutional Funds Act (UMIFA), which provides uniform rules governing the investment of endowment funds held by charitable institutions.[29] UMIFA was approved by the National Conference of Commissioners on Uniform States Laws (NCCUSL) in 1972, and established a standard of business care and prudence in the context of the operation of a charitable institution. Prior to UMIFA, each investment of a charitable institution was evaluated separately, an approach that led directors of charities to feel compelled to limit investments to fixed income investments dividend-paying stocks. UMIFA changed the law to permit an approach that is more in line with modern portfolio management theories, looking at the portfolio as a whole rather than investment by investment.[30] In 2006, the NCCUSL further modernized the standards applicable to charitable institution fund management and approved a revision of UMIFA entitled the Uniform Prudent Management of Institutional Funds Act (UPMIFA).[31] UPMIFA expanded the application of UMIFA to charitable trusts and incorporated the more modern standards of the Uniform Prudent Investor Act passed by NCCUSL in 1994. UPMIFA provides that, "[m]anagement and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution."[32]

In summary, debt financing increases the risk of an individual transaction, but that is not a reason to discourage all debt financing without regard to the level of risk and return of a charitable institution's investments as a whole, as the debt-financed income rules do. Moreover, the debt-financed income rules are unnecessary for this purpose because other laws govern investment standards with a more nuanced and aggregate approach that is consistent with modern investment theory.

An additional problem with the debt-financed income rules is that they have been applied in a rigid manner that makes formalistic distinctions between debt and leverage. As described above, the result is that the rules tax transactions which involve direct borrowing while permitting investors who use leverage in more sophisticated transactions to escape tax.

Recommendations

Rather than focusing on the use of blocker entities to avoid the unrelated debt-financed income rules, I urge Congress to evaluate the operation of the debt-financed income rules and to significantly restrict the application of these rules. Under current law, there is an exception for real estate transactions of pension funds and universities if the transactions meet certain requirements. This exception, and its requirements, should be used as the model for a broader exception applicable to all types of debt-financed property and available to all tax-exempt organizations.

First, the exception should not be limited to pension funds and universities. While some argument may exist that pension trusts are uniquely focused solely on investments and are therefore distinct from other exempt organizations, a similar argument cannot be made to distinguish colleges and universities from other tax-exempt organizations. Therefore, exceptions to the debt-financed income rules should apply to all tax-exempt organizations.

Further, the exception should not be limited to real estate. As discussed above, the current debt-financed income rules apply to many legitimate investment transactions that are not abusive and were not the intended target of the rules. The current real estate exception includes requirements that (i) the indebtedness be for a fixed amount; (ii) the seller not provide financing; and (iii) the lender not have the use of the property. These requirements should be retained as a condition to a new broader exception that applies to all debt-financed property.

Finally, the current real estate exception includes restrictions applicable to investments made through partnerships which are intended to prevent the transfer of tax benefits from tax-exempt partners to taxable partners. These restrictions are tailored to real estate transactions and do not lend themselves to application to invest-

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[29] According to the NCCUSL, UMIFA has been adopted in 47 states.

[30] When originally passed, UMIFA did not apply to charitable trusts. In 1992, the *Restatement (Third) of Trusts* adopted standards similar to UMIFA and reformulated the Prudent Man Rule to provide that borrowing is permissible if the tactic is "employed selectively and cautiously." *See* Restatement (Third) of Trusts (The Prudent Investor Rule), § 227 (1992). Two years later, the NCCSL approved the Uniform Prudent Investor Act and incorporated the principles of the Restatement and principles of modern portfolio management. As described above, these standards were further incorporated into UPMIFA in 2006.

[31] According to NCCUSL, UPMIFA has already been adopted by 13 states.

[32] UPMIFA § 3(e)(2).

ments in other property such as securities and other financial products. Although I am not aware of hedge funds and other investment partnerships being used to transfer tax benefits from tax-exempt partners to taxable partners, nevertheless, Congress should give the Treasury authority to promulgate regulations in the future if necessary to foreclose such transfers in non-real estate partnerships.

Conclusion

If Congress amends the unrelated debt-financed rules as suggested, tax-exempt investors will no longer be forced to invest offshore and use blocker entities to avoid the unrelated debt-financed income rules on legitimate investments. Further, the current disparate treatment between direct borrowing and leverage, and between different types of tax-exempt investors, will be eliminated.

I would be pleased to answer any questions you may have.

Mr. NEAL. Thank you, Ms. McDowell.

Our next panelist is Mr. Daniel Shapiro, a partner with Schulte, Roth & Zabel. Welcome, Mr. Shapiro.

STATEMENT OF DANIEL S. SHAPIRO, PARTNER, SCHULTE, ROTH & ZABEL, LLP, LONDON, ENGLAND

Mr. SHAPIRO. Thank you, Chairman Rangel, Ranking Member McCrery and Members of the Committee. I am Daniel Shapiro. I am a founding partner of the New York City law firm of Schulte, Roth & Zabel, and I am resident in that firm's London office.

I have provided tax advice to private investment funds for over 30 years. I appear today on behalf of the Managed Funds Association, whose members include professionals in hedge funds, funds of funds, and managed future funds.

In accordance with the Committee's request, MFA's prepared statement for the record and my summary remarks today focus principally on how hedge funds are structured, and in particular, as others have discussed, why U.S.-based hedge fund managers establish foreign funds outside of the United States and why U.S. tax-exempt organizations invest in those foreign funds.

Hedge funds sponsored by U.S. managers play an important role in the U.S. capital markets and make positive contributions to the U.S. economy. The ability of U.S. managers to compete globally for talented personnel for investment opportunities and for investors is influenced by many factors, including the U.S. tax system. Hedge funds are structured in accordance with established principles of Federal tax law and the structures promote congressional tax and economic policies. This includes the funds that U.S.-based managers establish outside the United States in order to compete with non-U.S. managers for passive investors from all over the world.

For more than 40 years, Congress has structured the Tax Code to encourage passive foreign investments in the U.S. by non-U.S. investors. Among other things, Congress has exempted most forms of interest payments made to foreign investors from U.S. withholding tax and it has likewise exempted their capital gains from U.S. taxes generally. Despite this advantageous treatment, for a variety of reasons, some of which have been mentioned, rather than investing as partners in U.S. hedge funds partnerships, most foreign investors strongly prefer to use foreign corporate hedge funds as a vehicle for their U.S. hedge fund investments. U.S. hedge fund managers would be competitively disadvantaged if they did not offer such foreign corporate structures to foreign investors.

As also has been discussed previously by two of the panelists, pension funds, university endowments, certain other tax-exempt organizations, such as foundations, also invest in foreign hedge funds sponsored by U.S. managers. They make their hedge fund investments into foreign hedge funds, as has been said, to avoid the application to that investment income of the technical unrelated business income tax provision. These provisions, sometimes referred to as UBIT, subject income of tax-exempt entities, generated through debt financing, to a 35 percent Federal tax. As has been mentioned, the UBIT rules would apply if a tax-exempt organization invested in a hedge fund in the U.S. structure as a limited partnership would use as leverage. But by investing in a foreign corporate hedge fund and not in a transparent U.S. partnership, the tax-exempt organization is not deemed to be using debt financing because the leverage used by the foreign corporate fund does not pass through the tax-exempt shareholder.

As mentioned, the conclusion that investments in foreign corporate funds by U.S. tax-exempt organizations does not trigger the adverse UBIT tax result has been specifically confirmed by a number of recent IRS rulings, as well as implicitly by Congress in connection with 1996 tax legislation. Moreover, from a tax policy point of view, as has been mentioned before, there appears to be very little basis for imposing UBIT on passive investment income received by a tax organization where it has no liability for the leverage used by the foreign fund, has no control over the funds investments or the extensive leverage, and does not incur any indebtedness to acquire or carry the investments where they would be taxed if they did. As this Committee knows, many tax-exempt organizations, especially universities, starting with Harvard and Yale, have been able to achieve substantial growth in their endowments by investing significant percentages of their assets in foreign hedge funds. If universities and other exempt entities, such as pension funds, which are increasing their allocations to foreign hedge funds and fund to funds, were subject to UBIT on such investments, their rate of return would be substantially diminished.

As noted, and I will not talk about this much because it was not our precise purpose, some managers defer the receipt of fees they receive from offshore funds. What I would just point out is that many foreign investors frequently expect these deferral elections to be made so that there is a resulting deferral which buttresses the alignment of interest between the U.S. manager and the foreign investor. The onerous tax rules, which you may be aware of, applicable to a U.S. taxpayer investing directly into one of his foreign funds, effectively prevent a manager from investing directly in the fund. So deferral of fees by U.S. managers, which allow those fees to continue to be invested during the deferral period only, along side the foreign investors do ultimately get taxed at the top income tax rate of 35 percent when they are received by the managers at the end of the deferral period, and they are subject to the comprehensive tax regulatory regime enacted by Congress in 2004 to govern deferred compensation arrangements.

MFA is aware that this Committee is considering various other tax policy issues, some related to carried interest, the application of the publicly-traded partnership rules, to public offerings, MFA

has significant reservations regarding some of these proposals and would welcome the opportunity to present its views on these issues to the Committee in greater detail as the legislative process moves forward.

Thank you.

[The prepared statement of Mr. Shapiro follows:]

STATEMENT OF

DANIEL S. SHAPIRO

ON BEHALF OF

THE MANAGED FUNDS ASSOCIATION

BEFORE THE

COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

SEPTEMBER 6, 2007

Chairman Rangel, Ranking Member McCrery and Members of the Committee, my name is Daniel S. Shapiro. I am a founding partner of the New York City law firm of Schulte Roth & Zabel LLP and am resident in the firm's London office. I have provided tax advice to private investment funds for over 30 years. I appear today on behalf of the Managed Funds Association, commonly known as MFA. MFA welcomes this opportunity to participate in the Committee's hearings on the manner in which private investment funds, their managers and their investors are taxed. In accordance with the Committee's request, this statement will focus principally on how hedge funds are structured and, in particular, on the reasons why U.S.-based hedge fund managers establish funds outside the United States and who invests in those funds.

MFA is the voice of the global alternative investment industry. Its members include professionals in hedge funds, funds of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policymakers and the media and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the over $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

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Introduction and Summary of Testimony

Hedge funds sponsored by U.S.-based managers play an important role in the U.S. capital markets and make positive contributions to the U.S. economy as a whole. These managers must, however, compete globally for talented personnel, for investment opportunities and for investors. Their ability to do so effectively is influenced by many factors, including the U.S. tax system.

Hedge funds are structured in accordance with well established principles of tax law, as set forth in the Internal Revenue Code, Treasury regulations, rulings by the Internal Revenue Service and other applicable legal authorities and this structure also promotes key Congressional tax and economic policies. This is true in the case of funds that U.S.-based hedge fund managers establish outside the United States in order to compete with non-U.S. managers for passive investors from Europe, Asia and elsewhere.

For more than 40 years, Congress has structured the tax code to encourage passive foreign investments in the U.S., both by foreign corporations and individuals. Among other things, Congress has exempted most forms of interest payments made to these passive investors from U.S. withholding tax and it has likewise exempted their capital gains from U.S. tax except to the extent they are derived from sales of U.S. real estate and certain U.S. real estate securites. Despite this advantageous treatment, most foreign investors utilize foreign corporations as the vehicle for their passive investments into the United States and U.S.-hedge fund managers would be competitively disadvantaged if they did not offer such a structure to foreign investors.

The foreign funds organized by U.S.-based hedge fund managers to attract foreign passive investors are corporations and they are subject to this same tax regime so long as they limit themselves to passive investment activities, including trading and investing in stocks, securities and commodities. These funds thus do not provide the ultimate foreign investors with more advantageous tax treatment on their U.S. investment income than they would receive if they invested directly. The foreign funds established by U.S.-based hedge fund managers simply

promote the Congressional policy to encourage passive foreign investment in the United States and at the same time enable U.S.-based managers to compete for those investors.

Pension funds, university endowments and certain other U.S. tax-exempt organizations also invest in foreign hedge funds sponsored by the U.S.-based managers. These organizations invest in hedge funds to maximize the investment returns they need to carry out their public interest missions. They structure their investments in this manner because, under a quite technical tax law provision, their investment returns would be reduced by the 35 percent unrelated business income tax if they invested in a U.S. hedge fund, organized as a partnership, that used leverage to enhance its returns. In such a case, the position of the tax-exempt investor vis-à-vis the fund is no different than if it had purchased the stock of a publicly traded company on the open market.

The use of foreign corporate funds by U.S.-tax exempt organizations does not trigger this adverse tax result and its use has been sanctioned by Internal Revenue Service rulings as well as implicitly by Congress in 1996. Moreover, from a tax policy standpoint, there appears to be little basis for imposing the unrelated business income tax on passive investment income received by a pension fund or other tax-exempt organization where it has no liability for the leverage used by the fund, has no control over the fund's investments or the extent of its use of leverage, and does not incur any indebtedness to acquire or carry its investment in the fund.

Some U.S.-based managers elect to defer receipt of a portion of the payments they receive from the offshore funds they sponsor. Foreign investors frequently expect these deferral elections to be made as the resulting deferrals buttress the alignment of interests between the manager and the investors. These deferrals are taxed in the U.S. at the top income tax rate of 35 percent when they are received by the managers at the end of the deferral period and they are subject to the comprehensive tax regulatory regime enacted by Congress in 2004 to govern deferred compensation arrangements by all business enterprises. These deferral arrangements also facilitate the ability of U.S.-based managers to establish deferred compensation plans for

their employees and this in turn enables these managers to compete for and retain talented personnel.

MFA is well aware that this Committee is also considering other tax policy proposals relating to hedge funds that are outside the requested scope of this statement. These proposals include the treatment of so-called "carried interests" and the application of the publicly-traded partnerships rules to public offerings of interests in hedge fund and private equity fund managers. These proposals are not unique to hedge funds. For example, many types of private investment funds provide carried interests. Moreover, many hedge fund managers already pay income tax at the top 35 percent rate on substantial portions of their carried interest income. As discussed below, MFA has significant reservations regarding these proposals and would welcome the opportunity to present its views on these issues to the Committee in greater detail as the legislative process moves forward.

II

Hedge Funds and Their Importance to the American Capital Markets

MFA welcomes the interest of the Committee in the hedge fund industry and is pleased to participate in the process by which the Committee will examine issues related to the manner in which these funds, their managers and investors are taxed. MFA believes that these issues are best addressed following an examination of the key characteristics that distinguish hedge funds from other private investment funds and of the important role hedge funds play in the American economy.

A. What is a "Hedge Fund"?

Hedge funds are part of what is commonly referred to as the alternative investment sector of the capital markets. This sector also includes private equity funds, venture capital funds, real estate funds, mezzanine debt funds, and structured debt funds, among others. In 1999, the President's Working Group on Financial Markets defined a hedge fund as "a private investment

pool that is professionally managed, not available to the general public and typically limited to high net worth individuals and institutional investors".

Other private investment pools share some of these same characteristics and, in MFA's view, hedge funds have five key characteristics, as follows:

> First, hedge funds pursue absolute returns, which are not correlated with stock market returns, and do so within defined risk parameters.
>
> Second, there is no single investment strategy that is common to all hedge funds.
>
> Third, there generally are no public offerings of interests in hedge funds, a fact which, in order to ensure compliance with the federal securities laws, results in substantial limitations on the ability of hedge funds and their managers to communicate with the public through public announcements of fund-specific investment results, advertisements, press interviews and open websites.
>
> Fourth, to comply with applicable securities laws, hedge funds generally are directly available only to high net worth individuals and institutional investors.
>
> Fifth, hedge fund managers profit principally by sharing in the returns earned by the funds themselves, and often make significant investments in the funds they manage, thus directly aligning the interests of the fund's manager with the interests of the investors in the fund.

B. Hedge Funds and the Capital Markets

As the President's Working Group on Financial Markets and its constituent members, including the Department of the Treasury, have repeatedly stated, hedge funds provide important benefits to the U.S. capital markets and to the American economy as a whole. For example, hedge funds are an important source of liquidity, not only in the traditional markets for equity securities, but in other markets such as those for distressed debt, convertible debt, and asset-

backed securities. As former Treasury Under Secretary Quarles stated in testimony presented to the Senate Banking Committee on May 16, 2006, U.S. markets are attractive to investors, both domestic and foreign, because they are among the deepest and most liquid in the world and "hedge funds are significant liquidity providers in many marketplaces".

In addition to providing liquidity in the form of risk capital, hedge funds promote price efficiency in the capital markets, contribute to capital formation in many sectors of the economy, and frequently identify new and emerging markets. Moreover, by being active participants in off-exchange derivatives transactions, such as currency and interest rate swaps, hedge funds contribute to the deep and liquid marketplace in such instruments that enables "Main Street" American businesses, as well as banks and others, to manage many of the risks inherent in their core businesses in an efficient and cost effective manner.

Hedge funds and other private investment funds also help keep the U.S. capital markets competitive. As Treasury Under Secretary Steel stated on February 27, 2007:

> United States capital markets are the envy of the world. Our markets are deep, efficient and transparent. Creativity, innovation and entrepreneurship have long been the hallmark of U.S. markets and their benefits to our economy are clear. Private pools of capital—which include venture capital, private equity, and hedge funds—have helped make us the world's leading financial innovator. As Secretary Paulson noted in a speech last November, private pools of capital are an essential part of what keeps our capital markets the most competitive in the world."

C. Hedge Fund Investors

As noted, hedge fund investments are directly available generally only to high net worth individuals and institutional investors. These institutional investors include pension funds, university endowments and other similar institutions. Hedge funds provide these investors with the opportunity to enhance significantly their ability to carry out their missions by diversifying their portfolios, earning stable returns and protecting their capital during periods of downward price movements in the public securities markets. The investment performance hedge funds have provided to tax-exempt investors arises from the fact that hedge fund managers seek returns that

are not correlated to the markets (as opposed to merely seeking to magnify market returns). Thus, while hedge funds' performance occasionally may not exceed mutual funds' performance in rising markets, they have in past years consistently provided positive and stable returns when the general markets are experiencing downturns. Thus, in the case of pension funds, for example, hedge fund investments can, in the context of a balanced and professionally managed portfolio, provide greater retirement security for millions of Americans in all walks of life, including teachers, law enforcement and fire officials, and municipal workers.

III

Technical Explanation of Hedge Fund Structures

As noted at the outset of this statement, hedge funds are structured in accordance with long established tax rules, as set forth in the Internal Revenue Code, Treasury regulations, Internal Revenue Service rulings, and other applicable authorities. As also noted, the typical hedge fund structure also promotes key Congressional tax policies, including those intended to encourage inbound investment into the United States.

A. Overview

A "hedge fund" with a U.S.-based manager typically consists of both a U.S.-based fund and a foreign fund, each of which has the same investment objectives. The U.S. fund is generally organized as a limited partnership and there is thus a single level of U.S. federal income tax on the fund's investment income, which is imposed at the partner level. This structure has been used, virtually without exception, by hedge funds and other private investment funds for decades. The principal investors in the U.S. fund are U.S.-based investors that are subject to the U.S. federal, state and local tax in their own right. The foreign fund is generally organized as a corporation (or as an entity that is eligible to elect to be classified as a "corporation" for U.S. tax purposes) and it is used as the vehicle for investment by those investors whose passive investment activities in the U.S. have, as discussed below, largely been exempted from tax by Congress and the foreign fund's structure simply facilitates that result.

In some cases, the U.S. fund and the foreign fund make parallel investments and in other cases (commonly referred to as "master-feeder" structures) the U.S. fund and the foreign fund (the "feeders") invest in a third fund (the "master fund") which makes the actual investments. In this structure, the master fund is typically organized as a partnership (or as an entity eligible to be taxed as a "partnership" for U.S. tax purposes).

B. U.S. Taxation of Foreign Investment

The provisions of the Internal Revenue Code governing foreign investment in the United States embody certain fundamental principles that, taken as a whole, reflect a clear Congressional intent to encourage non-U.S. persons to invest in the U.S. economy.

Current tax law distinguishes between those non-resident aliens and foreign corporations that are not engaged in a trade or business in the United States ("passive foreign investors") and those that are so engaged. In general, passive foreign investors are subject to U.S. tax only on their U.S. source dividends, certain interest, rents and royalties (collectively, "fixed or determinable, annual or periodical" gains, profits and income). This tax is generally collected via withholding at a flat 30 percent rate. Significantly, many types of interest payments made by U.S. payors, including the United States government, to passive foreign investors are not subject to U.S. withholding tax at all (e.g., under the so-called "portfolio interest" exemption). Finally, passive foreign investors are not subject to tax on their U.S. capital gains except in the case of gains from certain investments in U.S. real property and U.S. real property interests.

In contrast, non-resident aliens and foreign corporations that are engaged in a trade or business in the United States, and are thus not merely passive investors in the U.S. economy, are subject to U.S. tax on a net income basis, generally at a 35 percent rate. This tax generally is imposed with respect to all income, both U.S. source and foreign source, that is "effectively connected" with the U.S. trade or business. In addition, in such cases, a so-called "branch profits tax" is imposed on the repatriation of such "effectively connected income" and this may result in a combined effective tax rate that is substantially in excess of 50 percent.

As a result of these differences in the way foreign investors are taxed, passive foreign investors remain vigilant to ensure that their activities do not inadvertently fall within those categories of activities that may be treated as a U.S. trade or business. To ensure the steady flow of foreign investment funds into the United States, Congress acted as long ago as the Foreign Investors Tax Act of 1966 to provide certainty to passive foreign investors whose activities within the U.S. capital markets consist principally of trading or investing in stock, securities and commodities. Specifically, Congress enacted statutory safe harbors providing that the proprietary trading of, and investing in, stocks, securities and commodities will not be treated as engaging in the conduct of a trade or business within the United States. As the Committee is well aware, for many years the proprietary trading safe harbor for stocks and securities was available to foreign corporations (including most foreign hedge funds) only if the foreign corporation maintained its "principal office" outside the United States. In 1997, Congress amended the law to eliminate this requirement in order to stimulate foreign funds and others to increase the number of employees and service providers based in the United States. Most if not all foreign hedge funds structure their activities to fall within these two proprietary trading safe harbors.

C. Taxation of Foreign Funds and Non U.S. Investors in Foreign Funds

As noted, foreign hedge funds sponsored by U.S.-based managers are generally organized as corporations or as entities that can elect, under Treasury regulations, to be taxed as corporations for U.S. tax purposes, and are located in a tax-neutral jurisdiction to avoid double taxation of the foreign investors. The corporate structure is used to enable the foreign fund to attract investors from the U.K., Europe, Asia and elsewhere. These investors insist upon such a structure principally to ensure that their other assets (i.e., the assets they do not invest in the fund) will not be subjected to U.S. tax should the foreign fund inadvertently engage in activities that are found to constitute the conduct of a trade or business within the United States. Absent such a structure, U.S.-based fund managers would not be able to compete with fund managers based in

the U.K., Europe, Asia and elsewhere for non-U.S. investors who wish to invest in the U.S. on a passive basis.

This structure does not create new U.S. income tax benefits for foreign passive investors that they could not obtain if they were direct investors in the United States because the foreign fund is subject to U.S. withholding taxes on the dividends, certain interest, rents and royalties it receives to the same extent as any other passive foreign investor. Moreover, while the foreign fund is exempt from U.S. tax on its capital gains (except those attributable to the disposition of U.S. real property interests), that exemption is available to all passive foreign investors. Despite this advantageous treatment of passive foreign investors, most foreign investors utilize foreign corporations as the vehicle for their passive investments in the United States and they would be unlikely to invest with U.S.-based hedge fund managers if those managers did not provide such a structure. In short, the use of a foreign fund enables U.S.-based managers to compete for passive foreign investors.

D. U.S. Tax-Exempt Investors in Offshore Funds

Pension funds, university endowments and most other U.S. tax-exempt organizations are generally exempt from U.S. tax on their passive investment income, but they are typically subject to the unrelated business income tax ("UBIT"). This tax is generally imposed at the regular corporate income tax rate of 35 percent.

UBIT was originally enacted in 1950 to prevent tax-exempt organizations from exploiting their tax exempt status by acquiring an unrelated operating businesses and enabling that business to compete unfairly with taxable enterprises. The UBIT base was thereafter expanded by Congress to include so-called "debt financed income". The legislative history of the debt-financed income amendment suggests that Congress was principally concerned with abuses of the original legislation through techniques such as leveraged acquisitions of operating business assets. Nevertheless, the statutory definition of "debt financed income" has a much broader reach

and includes such items as dividends on stock of a publicly traded company if the stock was purchased through a margin account.

As the Committee is well aware, hedge funds frequently employ leverage as an integral part of their investment strategies to enhance returns to investors. The amount of leverage used by an individual manager of a hedge fund varies widely, depending on, among other things, the particular manager's investment strategy, view of the market and the current cost of borrowing. Under the current UBIT rules, if a tax-exempt organization invests in a U.S. hedge fund organized as a partnership, a portion of the fund's leverage would be imputed to the tax-exempt organization in its capacity as a limited partner (passive investor) in the fund. The imputed leverage would expose the tax-exempt organization to liability for UBIT on its investment returns from the fund even if, as is almost universally the case, the tax-exempt organization had no liability for the fund's debts, had no control over the fund's investments and did not incur any indebtedness to acquire or carry its investment in the fund.

As a result of the application of UBIT to investments in U.S. hedge funds that use leverage, tax-exempt organizations have for some years made their hedge fund investments through the foreign fund (a corporation, for the reasons discussed above). Under current law, none of the leverage used by the foreign fund is imputed to the tax-exempt shareholder (passive investor). Thus, gains realized by the tax-exempt shareholder on a complete or partial redemption of its interest in the foreign fund are not subject to UBIT.

Both Congress and the Internal Revenue Service have sanctioned the use of these structures by tax-exempt organizations for investments in foreign funds. Specifically, while the passive foreign investment company ("PFIC") rules enacted in 1986 apply onerous tax rules to most U.S. taxpayers investing in a foreign hedge fund, the implementing regulations exempt, in accordance with Congressional intent, U.S. tax-exempt organizations from the PFIC rules. In 1996, Congress considered proposals to apply a "look through" rule under which dividend income received by a U.S. tax-exempt organization from a controlled foreign corporation would

be subject to UBIT to the same extent the underlying income would be taxed under UBIT if earned directly by the tax-exempt organization. Congress flatly rejected such an approach except in those limited cases where the foreign corporation was actively engaged in an insurance business and thus presented the potential for the very type of unfair competition at which the original UBIT provisions were aimed.

Moreover, in its general explanation of the 1996 legislation, the staff of the Joint Committee on Taxation stated that Congress believed that the prior IRS rulings declining to impose such a look through rule were correct and, since the 1996 legislation, the IRS has issued an additional series of "no look through" rulings, including rulings to U.S. tax-exempt organizations with respect to investments in foreign funds.

Current practice is not merely a technically correct application of the current tax code. It is also consistent with the underlying purposes of UBIT. When a tax-exempt organization invests in a foreign hedge fund, it does not incur any debt to finance the investment (or else UBIT would apply to that extent), it has no liability for any of the debt incurred by the fund, and it has no control over either the investments made by the fund or the extent of leverage employed by the fund in doing so. In short, the tax-exempt organization receives only passive investment income and its position vis-à-vis the foreign fund is no different than if it had purchased shares of corporate stock (and many corporations use often substantial leverage in connection their business operations).

As the Committee is aware, many tax-exempt organizations, especially universities such as Harvard, Yale, Stanford, North Carolina, Virginia and many others across the country, have been able to achieve significant growth in their endowment funds by investing in a wide variety of hedge funds. Virtually all of those investments have been made, either directly or through funds of funds in foreign hedge funds, many of which use substantial leverage. If the universities, and other tax-exempt organizations such as pension funds that have also been increasing their allocations to hedge funds, were to be made subject to UBIT on those

investments merely because the managers of the foreign funds decided to seek enhanced returns through leverage, their rates of return would be very materially diminished. The potential for such marked adverse effects of a change in the current tax rules should therefore be given the most careful consideration.

E. Payments to U.S. Managers

Hedge fund managers frequently receive both fixed payments (based on a percentage of the value of assets under management) and incentive payments (based on investment performance) from the foreign funds they sponsor. These payments are subject to U.S. tax as ordinary income when received. In some instances, the manager may elect to defer the payment of a portion of these amounts to a subsequent taxable year. In those cases, the deferrals, together with any actual or notional earnings thereon, are subject to U.S. tax as ordinary income when received at the end of the relevant deferral period and are taxed at the top 35 percent tax rate.

Foreign investors frequently expect the election of such deferrals to be made by the manager since the deferrals buttress the continuing alignment of interests between the manager and the investors. As noted above, the onerous PFIC rules make it very burdensome for the manager to invest directly in a foreign fund, as they frequently do in U.S. funds.

Moreover, the deferred amounts remain as general assets of the foreign fund and are subject to risk of loss in the event of future adverse investment performance or if the foreign fund becomes insolvent and is unable to meet the claims of creditors. Thus, as to its elective deferrals, the manager is simply a general unsecured creditor of the fund. In this sense, these deferrals differ from tax-qualified arrangements such as traditional pension plans and section 401(k) plans. Those plans are funded and the amounts set aside in the trusts or other funding vehicles can be used only to pay benefits and are not subject to claims of the employer's creditors.

These elective deferrals by fund managers generally are subject to the rigorous regulatory regime for nonqualified deferred compensation arrangements enacted by Congress in 2004, as are any deferred compensation plans maintained by the manager for its employees and other service

providers. Some hedge fund managers use plans in this latter category to attract and retain key personnel through deferred compensation arrangements that are linked to the manager's elective deferrals with the foreign funds it sponsors. Careful thought should be given to these issues prior to the enactment of tax policy changes that would limit their ability to do so.

As set forth in section 409A of the Internal Revenue Code, the 2004 legislation imposes strict rules governing deferral elections, the circumstances under which deferred amounts can be paid, and the limited conditions under which payment of deferred amounts can be accelerated. Final regulations under section 409A were issued by the Department of the Treasury and the Internal Revenue Service earlier this year. Those regulations confirm that section 409A does in fact generally apply to deferral arrangements involving hedge fund managers and that, accordingly, plans involving hedge fund managers are subject to the same rules that apply to all other taxpayers. MFA has cooperated fully with the Treasury and the Internal Revenue Service to ensure the proper and timely implementation of section 409A and it will continue to do so.

IV

Concluding Observations

MFA is well aware that the tax treatment of foreign funds is but one of a series of tax policy proposals concerning hedge funds and other alternative investment funds that are under active consideration by this Committee and others. These include H.R. 2834, which would alter the tax treatment of income attributable to so-called carried interests and S. 1624, which would limit the ability of investment advisory firms to engage in public offerings of equity interests while maintaining their "partnership" tax status. These and other similar proposals would reverse long standing tax policies related to partnerships and could have potentially significant and disparate effects on the way in which capital is raised and deployed in major segments of the economy, with consequent effects on economic development and job creation. MFA believes that Congress should carefully consider the potential macroeconomic effects in deciding whether to enact such tax law changes.

Similarly, MFA believes that Congress should carefully consider the impact of the pending proposals on the continuing erosion of the traditional position of the United States as the world's leading financial center and source of financial innovation. This process is already underway as other countries seek to exploit their natural advantages, including location, and the capital markets continue to be increasingly global in nature. U.S.-based hedge fund managers are important to the competitive position of the U.S. in the financial services sector. These managers compete globally for investors, key personnel and investment opportunities. Tax legislation that compromises their ability to compete effectively in any of these areas could have adverse effects on the competitive position of the U.S. as a global financial center.

As noted above, these proposals are not unique to hedge funds. For example, many types of private investment funds provide carried interests. Moreover, many hedge fund managers already pay income tax at the top 35 percent rate on substantial portions of the income attributable to carried interests in the U.S. funds they sponsor as a large percentage of such income is attributable to trading profits from stocks and securities held for less than a year. H.R. 2834 does not, however, merely raise the rate of tax on income from carried interests. It also recharacterizes such income as compensation for services. As other testimony presented to this Committee in connection with this hearing suggests, such recharacterization of what would otherwise be short or long term capital gains in this context appears to be largely unprecedented. Moreover, it could have significant adverse collateral effects under other provisions of the Internal Revenue Code and under state and local tax laws.

MFA also has significant policy concerns with S. 1624, which would limit the ability of investment fund management companies from engaging in public offerings unless they forfeited their "partnership" tax status. MFA questions whether there is a compelling tax policy rationale for S. 1624. For example, the assets of these companies have almost always been held by partnerships and MFA thus doubts that public offerings by such companies should be characterized as increasing the potential for erosion of the corporate tax base. Moreover, MFA

questions whether investment managers should be subject to a different tax regime than publicly traded partnerships organized in other sectors, such as oil and gas, commodities, substitute fuels, etc. MFA also believes that Congress should give careful consideration to the fact that fund managers that have engaged, or in the future may do so, in public offerings are important participants in the U.S. capital markets and that public offerings by such firms will both increase transparency due to the disclosure requirements of the federal securities laws and facilitate succession arrangements designed to enhance the stability of these firms.

MFA would welcome the opportunity to present its views on H.R. 2834, S. 1624 and similar proposals to the Committee in greater detail.

* * *

MFA appreciates this opportunity to present its views to the Committee on hedge fund structures and will continue to work with the Committee and others concerned as the legislative process moves forward.

Mr. NEAL. Thank you, Mr. Shapiro. By an unanimous consent agreement just prior to moving over to the House floor, the Chair will recognize Mr. Blumenauer and then Mr. Cantor.

Mr. BLUMENAUER. Thank you, Mr. Chairman. We are in the midst, as you know, of a series of fascinating panels here helping us to understand some very complex interrelationships dealing with issues of hedge funds, how we are treating investment income, dealing with the alternative minimum tax and in particular what we are going to do with the alternative minimum tax as it has broader applications to people. But there is a thread of tax equity and revenue stability that goes through this. I was just curious if I could to start, Mr. Shapiro, with you, you are referencing, for instance, maybe it is not directly on point but it is in the back of people's minds about ways that compensation can be deferred, rolled over time, and you were talking about the alignment of interest that some feel is desirable, makes sense to me, hedge fund managers, the people that are participating in it, is there any reason why this alignment of interest for a sub-set of hedge fund managers is any different than an alignment of interest that people may have for other valued employees in other business enterprises? Are they somehow special or are there other broader applications that would obtain from the alignment of interest?

Mr. SHAPIRO. Well, there are—if I understand your question, there are deferred compensation arrangements of various kinds that apply.

Mr. BLUMENAUER. There are but they are limited in nature and not every employee has the employee to have this broad deferral, and I am just wondering if there is something special about hedge fund managers that would not be applied to other key and valued employees, such as if we are going to do this, that we should apply it more broadly?

Mr. SHAPIRO. Well, I think that various key employees are offered deferred compensation arrangements, some of them are offered those by U.S. corporations that induce their employees to stay with them by creating deferred fee arrangements. If you are talking about how far and how wide should those deferred fee arrangements be applied, I think that it depends on each corporation's view of how valuable their employees are and whether they want to make those arrangements.

Mr. BLUMENAUER. But they are not unique among other millions of valued employees who are employed by other entities.

Mr. SHAPIRO. No, I agree. I think that this arrangement, that the hedge funds have established with offshore funds happens because of the structure of the way their fees are paid from the offshore funds. I think that it is one of the kinds of deferred arrangements, all of which are now subject to very serious regulatory rules about how those deferrals have to be elected at the beginning of the year and how the deferral arrangements have to be structured to meet various tax requirements.

Mr. BLUMENAUER. One of the things the Committee is wrestling with is to avoid the application of the alternative minimum tax to some 27 million American taxpaying families next year, which virtually everybody says was never intended to be the purpose. One of the reasons 27 million families are subjected to it is

because we are now treating as a tax loophole that needs to be closed things like paying for your child's education, saving for your future, paying your state and local property taxes, these are tax preference items that get added back in in the computation. So, we are looking at ways to fix it. Is there any reason why we should not add back to the alternative minimum tax some of the tax preferences and benefits that accrue to hedge fund managers that mean that most of them are not subjected to the alternative minimum tax, is that a legitimate—is there any reason we should not consider adding back those tax preferences as opposed to somebody paying their local property taxes or claiming a child income tax credit?

Mr. SHAPIRO. Look, I think if the effort is being made to deal with AMT, there are a lot of ways to get at it and one is to increase tax rates, the other is to change the way the AMT works to increase the amount that people have to earn before they are subject to the AMT.

Mr. BLUMENAUER. No, I am referring specifically if today the child tax credit is a preference that gets added back, if paying your local property taxes is added back, isn't it reasonable that we should consider adding back some of the unique tax benefits that flow to hedge fund managers that in many cases they are not paying the alternative tax?

Mr. SHAPIRO. But there are a variety of tax benefits that many kinds of investors and employees and managers have. I think it is all on the table for consideration. I do not have a particular view as to which one you should, but I think as this Committee thinks about how to deal with AMT, I assume everything is up for grabs and I assume that issue could be considered by you, yes.

Mr. BLUMENAUER. Well, I appreciate, Mr. Chairman, your courtesy, and I do appreciate the testimony here helping us round out a bigger, broader picture and more nuanced because we certainly do not want to get into an area of unintended consequences. I found this very helpful. Thank you.

Mr. NEAL. Thank the gentleman. The gentleman from Virginia, Mr. Cantor is recognized to inquire.

Mr. CANTOR. I think the Chairman, and I want to thank the panelists too for their indulgence and for being here all day waiting for us to return from the floor.

Mr. Chairman, I first of all would like to in my opinion set the record straight from some of the comments that were made earlier, particularly by the gentleman from Texas, when he indicated that there was no willingness on the part of the Republicans to try and address the AMT problem and would note that every year since at least I was here since 2001 there has been an attempt to hold harmless, if you will, or apply a patch. I do not think it is fair to say that we were not willing, I think we are all here trying to address that. Really, I think none of us would be here if we had not seen the veto by President Clinton in 1999 of the AMT fix.

Be that as it may, we now find ourselves on a hunt for more revenues somehow since we in this body have a very poor track record of cutting spending and trying to reset the economic or fiscal model due to our entitlement scenario, we find ourselves in hunt of more revenue to address the AMT situation. In my opinion, we saw the

Bachus-Grassley bill focus the publicly traded partnerships and want to somehow penalize them for the profits that they were experiencing and their investors were experiencing.

Next, Mr. Chairman, you along with our colleague from Michigan put in a bill, which in my opinion not only targets one of the most innovative sectors of our economy that has really performed a function of being an agent for change, creating jobs and opportunity, but also now may very well apply to the mom and pop partnership millions of Americans that are putting their capital at risk everyday to create opportunity for their families and communities.

So, my question, Mr. Chairman, with all of that, we have seen the partnership structure, we have seen the favored treatment of capital gains produce an incredible increase in investment and productivity in this economy. My question for Mr. Shapiro and then to Ms. Gallagher and Ms. McDowell, if we were to, as some would want, not me included, raise or change the character of the income on carried interest so affect the return that the fund managers have, would that necessarily, in my opinion, translate into a change in the two and 20 formula that most of the private equity funds have? Then would we see the nonprofit and the retirement funds also be negatively impacted by that increase in taxes? Mr. Shapiro.

Mr. SHAPIRO. I think sitting here it is very hard to predict whether private equity or hedge fund managers, general partners, if they were faced with higher taxation would believe that the response should be increasing the two and 20, which is not always what is charged but it has sort of become the mantra for what most managers get in either side of the private equity hedge funds. It is simply too hard for me to predict that. I think that at some point there is a level of resistance on the part of investors, and I think that tax-exempt institutions in particular who have a lot of leverage to use, to use the often-cited word today, would probably not be happy paying significantly higher fees so the result might well be, even though the managers would say, "Well, look, we are paying much higher taxes, we need to generate more fees," that that cost would really be picked up by the managers and by the general partners of private equity funds.

Mr. CANTOR. So, is it in your opinion fair to say though that the level of investment would continue and disregard—given the players in the investment partnerships as well as the partners themselves, disregard the increased cost?

Mr. SHAPIRO. Well, look, I think that the hedge fund and private equity areas, as you have said, have been incredibly good to this country and the creativity and the growth of many of the industries in this country have been fueled by the activity of the best and brightest who tend to go into the private equity and hedge fund world. I think they will continue to go in that world as long as there are incentives for them to do it. One of the incentives is they get people to invest in their funds. Another incentive is that they have the potential to get more favored tax treatment if they run their funds effectively and they can generate long-term capital gains. So, I think that the industries would be hurt, I do not think they would be put out of business by changes in the tax law.

Mr. CANTOR. I would then, Mr. Chairman, if I could turn to Ms. Gallagher and/or Ms. McDowell to address some of the articles, there was an editorial in Pension and Investments which talked about the harm to retirees if the tax structure and the nature of the income to managers was increased on private equity funds?

Ms. GALLAGHER. First, I would like to be clear that the Council does not have any position on carried interest. We are here strictly to discuss the section 514 unrelated debt-financed property problem. Changes, any changes that effect return on investment are clearly going to be weighed by the investor. As Mr. Shapiro indicates, I think there would be some question as to how the managers would react and whether they would absorb those increased costs out of their compensation rather than pass them along to investors. No one is compelled to invest in hedge funds, so I think certainly what the return is predicted to be is the factor in what you are going to do.

Ms. MCDOWELL. I am not really an expert in how managers react and so I can only guess, but I would echo what Ms. Gallagher has said. As far as tax-exempt investors are concerned, they are going to manage their money in order to get the best return they can consistent with prudence and their fiduciary duties to manage the investments of charities. The hedge funds are attractive because they have had such high rates of return. If the managers begin to take a larger cut which reduces the return, then of course tax-exempt investors, just like others, would lose interest in these funds.

Mr. NEAL. I thank you. The gentleman from New Jersey, Mr. Pascrell, will inquire.

Mr. PASCRELL. Thank you, Mr. Chairman. In a full-day hearing to really I believe dissect what fortunes for the fortunate really means, and regardless of what subject we are talking about here today, I find it fairly incredible that, Mr. Chairman, before I ask my question, that I have heard people's talk today about the AMT tax and that tax will become the tax system by 2016 if we do not do anything about that. It will totally become the tax system. The second thing that I have concluded today is that there is no doubt in my mind that the AMT is a mask to the true cost of the tax cuts of 2001 and 2003. I have heard no counter-argument to that. That more than 60 percent of the cost of the AMT represents the deferred cost of 2001 and 2003 tax cuts. So, we are here to give relief to the middle class because they have been had. On the average, the individual who received a $5,000 tax cut had to return approximately $3,000 of it at what cost? We know there has been a shift of who is being taxed over the last 30 years. We use to tax income more than assets. Now we tax assets more than income. What is the result of that, Mr. Shay, in your mind and in your thoughts today, is what I said accurate or inaccurate and what are the consequences if so?

Mr. SHAY. I am not sure I fully understand what you mean by taxing assets more than income. My topic was really the topic of international taxation but tying it back to that, clearly the Committee has to grapple with how to address the issues of the AMT and frankly much bigger issues down the road than the AMT because of the sort of structural imbalance that we have fiscally be-

tween the commitments that have been made and are being made and the revenue base that is going to need to be relied on to meet those commitments.

Mr. PASCRELL. Would anyone on the panel like to respond to that first question that I laid on the table. I know we are talking about the off shoring, and I know we are not discussing directly the AMT, would anyone like to respond to my question about the difference of taxing assets compared to income and who suffers from that or who gains from that and who is in a better position? Okay, let me ask the next question then. How much money is protected when one invests offshore? Always bound to be a compelling question. I would like to put this question to the entire panel. Earlier this year, the New York Times published an article entitled, "Managers Use Hedge Funds as Big IRAs." According to this article, "Many Americans squirrel away as much as they can into retirement investment accounts like 401(k)s and IRAs that allow them to compound their earnings tax free. The accounts also reduce what they owe when tax day rolls around. For the average person, however, the government strictly limits the contributions to about $20,000 a year. Then there are people who work at hedge funds. A lot of the hedge fund managers earning astronomical paychecks, making headlines these days are able to postpone paying taxes on much of that income for 10 years or more." My question is this, does anyone think that it is fair that hedge fund managers are able to defer paying taxes on a larger portion of their compensation than ordinary Americans? Who would like to take a crack at that question? Mr. Metzger.

Mr. METZGER. Many ordinary American taxpayers defer on their income. For example, if someone buys a piece of land for $100, which appreciates in value to $250 and the person takes a mortgage out on it for $200, that appreciation is not being taxed even though the person who made that investment is able to take the cash out. Or, for example, you have someone who buys stock for $100, which appreciates to $200, then that person posts that security as collateral to buy other stock. Or you have ordinary Americans who defer their year-end bonuses past December 31st but get paid before March 15th of the next year. So, you do have deferral all across the board. You may have hedge fund managers deferring, as well as ordinary Americans. The issue is whether or not we want to tax economic gain when there is no cash offsetting it.

Mr. PASCRELL. What are your thoughts?

Mr. METZGER. I am not an expert—well, let me say that I believe that when taxpayers cash out their economic gain, perhaps they should be realization events. So, for example, if you hold section 1256 regulated futures contracts, they have to be marked to market. Whether or not you sell those contracts by the end of the year, you pay taxes on the unrealized gains or losses. You have section 475, which is mandatory for dealers, they have to mark to market their positions whether they sell them or not. So, to some extent, the Tax Code already addresses some of these instances where unrealized income is taxed.

Mr. PASCRELL. Thank you.

Mr. NEAL. Thank you, thank the gentleman. The gentleman from Illinois, Mr. Emanuel, is recognized to inquire.

Mr. EMANUEL. Thank you, Mr. Chairman. I am in the same line of questions as it leads to the issue of deferral compensation. First I have legislation on this and I come from this view, working with and knowing a number of individuals, one is there is nobody cheating the system. This is an opportunity to do it. It is perfectly legal. What is different is nobody we represent, whether it is IRAs or 401(k) deferrals, actually can structure a way to pay for their kids' college education and have it in an offshore fund. There is a difference for what a family is allowed for their IRA and for their 401(k) than certain people—not just the size of a dollar but one issue is they are allowed to do it.

The second is can you structure—the first question is actually is it fair for them to do something that others cannot? Second, can you structure in the Tax Code a way that allows I think the universities and pensions and other entities to invest in onshore entities so that would not be the only way they could do their compensation? My instincts tell me, and I have talked to a number of experts, is the answer to that is yes. I think the managers of the hedge of funds have a legitimate concern that they would lose that money to international hedge fund competitors, so what we should do is structure a way that they can onshore raise the capital for their funds from the universities, from the endowments, from the pensions so they can invest here but also then pay compensation here.

Last, although a lot of them use the technique, that is the hedge funds, to retain talented employees and have them invested in the fund, there are other ways to do retention compensation that does not basically have a big gaping hole in my view in the equity of the Tax Code. So I want to get to I think the fundamental question because I think a lot of them have legitimate concerns, that is those who run the hedge funds, can you structure the law in a way, and, Mr. Metzger, I want to follow-up then with you since you answered the first time, that the universities, the pensions, the endowments, et cetera, can invest in funds that are based here in the United States and do not have to be offshore from a tax purposes?

Mr. METZGER. Sure, if Congress makes some changes to section 514, the incentive that the tax-exempt investors have to invest offshore could disappear, particularly in the area of funds that employ leverage. If Congress says that the leverage used by hedge funds is not considered unrelated debt-financed income, then tax-exempt investors should lose their motivation to invest offshore. But bear in mind—you have not asked me this question but I just want to throw this in—if in fact, Congress were to treat all income from carried interests as ordinary income, some hedge fund advisers might not accept tax-exempt money in the onshore funds. They may force them to invest offshore because they will want to take advantage of the deferral.

Mr. EMANUEL. Your answer, how would you resolve that problem? You do not want to put anybody at a competitive disadvantage but you want to deal with—because one of the fundamentals, besides revenue here, you have to have fairness in the system. If a family I represent on the northwest side of the City of Chicago feels like all they can put aside for 401(k) or IRA is up to about $20,000 but other people have $145 million of deferred income,

there is a sense that not that somebody earned more but somebody is getting a break that they cannot get and never can. You fundamentally put a crack in the Tax Code in the sense it is not a level playing field, that is not a good thing not just for revenue raising, just a sense that we are all in this together and that we have the same rules that apply across the board. So, I understand that you are saying it may force some of the funds to only raise capital.

Mr. METZGER. I am saying that if they have the opportunity to take tax-exempt money, they might rather take it in the offshore. That is assuming that all carried interest is taxed as ordinary.

Mr. EMANUEL. That is assuming that.

Mr. METZGER. That is assuming.

Mr. EMANUEL. Okay. Second, do you have any—and this is open to anybody, does anybody have any sense of how much revenue there is here? I have seen all the articles of the top 10, top 25 hedge fund managers, et cetera, how much from a revenue side if we dealt with this offshore issue in deferral, how much revenue would it be as it relates on the tax side, does anybody have a guesstimate? No? Okay. I yield back, Mr. Chairman.

Mr. NEAL. That was a chance for them to improve their name recognition within the industry. The Chair would recognize Mr. McCrery to inquire.

Mr. MCCRERY. Thank you, Mr. Chairman. Mr. Shay, I was very interested in your testimony as it regards what I consider to be proposals to simplify the corporate Tax Code in this country, the international Tax Code if you will. In your testimony, I did not hear you say it orally, but in your testimony, your written testimony, you talk about doing these changes with deferral and so forth in the context of lowering the overall corporate tax rate in this country. That to me is a very attractive proposal, which I think is necessary if we are going to stay competitive in terms of attracting capital for corporate investment and allowing our domestic corporations to compete globally. Have you thought about where there could be a corporate rate, assuming we keep the corporate income tax, where we should put the corporate rate in order to do away with deferral? In other words, is there a line at which corporations in this country would say, gee, we wouldn't mind doing away with deferral assuming a reasonable foreign tax credit regime if our corporate rate were "X"?

Mr. SHAY. Let me be clear that as an initial matter, the changes I would propose, I would propose without—independently of reducing the corporate rate, if one were concerned about the effect of those changes on the competitiveness of U.S. companies and wanted to devote the revenue of those changes instead of to the AMT to that issue, there has been some work on what a fairly broad amount of these changes would do and where you could bring the rate down to. I am not remembering it off the top of my head but it is I think still north of 30, the top corporate rate now is 35 percent, my recollection it is still somewhat north of 30 percent. Others can correct me on that. There is actually a paper on that that is cited in materials that goes into that issue. Sorry?

Mr. MCCRERY. Is what you are saying that the money that we would recoup from doing away with deferral, if applied to the cor-

porate rate would get it down to the low thirties or something like that, is that what you are saying?

Mr. SHAY. I really want to be very cautious. I am trying to remember whether the paper I was looking at included other changes as well but certainly——

Mr. MCCRERY. That is not what I am suggesting. I am not suggesting simply taking the revenue that we would recoup by doing away with deferral and applying it to the corporate rate, what I am suggesting is that we find a corporate rate, and I am thinking much lower than 30 percent, at which domestic corporations, those who do business overseas, who have overseas operations, who now use deferral in order to be competitive, a rate at which they would say, "We do not need deferral anymore. If you are going to have the rate at this level, we do not need deferral, we can compete." That is my point. I just wondered if you had looked at that from a competitiveness standpoint and obviously you have not?

Mr. SHAY. No, I would defer that to some of the economists. There have been some studies I can actually direct your staff to where the answer to that would be.

Mr. MCCRERY. That would be great. Thank you. Mr. Shapiro, thank you and welcome. Did you come from London to be here?

Mr. SHAPIRO. Came last night and leaving tonight.

Mr. MCCRERY. Oh, my goodness, well, we really appreciate your making a quick trip to assist us here. There was some questioning from Mr. Cantor and maybe one or two others about how fund managers would react if their tax rates went up and all of you said, "Well, gee, we do not know how fund managers would react." Let me ask it a different way: If fund managers in this country were to react to the increase in their taxes to 35 percent from 15 percent for the carried interest by saying to their potential investors, "Well, you now need to pay us two and 30," is it plausible that some of those investors might say, "I can get two and 20 in London, I think I will take my money to London"?

Mr. SHAPIRO. I am not sure an investor would take his money to London for that reason. I will say that the reason I am in London is because having been in this business for a long time, we recognize that London has become very competitive in the world of hedge funds and private equity funds. Taxes is only a part of that. I think that the difference in rates, I think investors, managers will not move just for a difference in rates but managers are mobile. We see increasingly U.S. managers functioning in London, albeit they all pay U.S. taxes and they have British taxes to pay and they get a credit against their U.S. taxes for the UK taxes, but it is not a good thing necessarily for the U.S. that highly skilled U.S. managers, both private equity and especially hedge fund managers, are functioning in London today and paying most of their taxes to the UK with a credit against their U.S. tax because even though in theory they owe U.S. tax, they get a full credit for the tax so that one of the things I think this Committee needs to be mindful of as you develop these proposals as it relates to managers is not to drive managers to think about moving to places like London and indeed managers are thinking of moving to Switzerland and other countries, Monaco, where the tax rates are significantly lower. Now if you are a U.S. manager and you are a U.S. citizen, you are not

going to be changing your tax bracket as a result of that. So, taxes is just one of the factors I think that would come into play.

Mr. MCCRERY. You talked more about what managers would do, again I asked what the money would do, might the money be invested—in other words, if a group of managers here said, "We are going to charge you more because we are having to pay a higher tax rate," might the money go to London or somewhere else where they would say, "We are only going to charge 20 percent"?

Mr. SHAPIRO. My honest view is that the institutional investors, who are by far the biggest and growing in scope in terms of where both private equity and hedge funds are raising their money, they are going to be investing their money not based on the fees that are being charged but based on the results. We all know that there are managers——

Mr. MCCRERY. Well, I know that but let's assume all other things being equal, Mr. Shapiro——

Mr. SHAPIRO. Right.

Mr. MCCRERY [continuing]. If Carlyle here, considers to be just as good as you guys——

Mr. SHAPIRO. Right.

Mr. MCCRERY [continuing]. Everything else is equal, you are going to charge them 20 percent carried interest, Carlyle has to charge them 25 percent because of a higher tax rate, where are they going to put their money?

Mr. SHAPIRO. I think at the margin it can make a significant difference. I think institutions—if the managers feel they have to raise their rates to be able to pay higher taxes, institutions will begin to resist that and look to places where the rates are not quite as high.

Mr. MCCRERY. Thank you.

Mr. NEAL. Thank the gentleman. The gentleman from Maryland, Mr. Van Hollen, will inquire.

Mr. VAN HOLLEN. Thank you, Mr. Chairman. I had a few questions for Ms. Gallagher and Ms. McDowell to follow-up on your testimony. Ms. Gallagher, you said in your testimony if the section 514 of the debt-financed property rules did not apply to the hedge fund investments, the tax-exempts would be able to invest directly in U.S. hedge funds and use of the offshore blockers would end, and that you believe that that can be accomplished without creating new opportunities for abuse, the kind of sham transactions. I gather, Ms. McDowell, from reading your testimony that you share that view. If you could each just give some idea if you know what the magnitude of dollars we are talking about is in terms of the amount that would now be invested onshore instead of offshore? Number two, if you could just elaborate a little, Ms. McDowell, on your proposals on how to structure that to make sure that we do not allow sham transactions but accomplish the goal of putting these investments back onshore but without allowing abuses? So, I would appreciate any further elaboration that each of you have on that topic?

Ms. GALLAGHER. I am sorry, Mr. Van Hollen, I really do not know the answer to your question as to the magnitude of the dollars involved. It is substantial. I do want to stress though that while we are using offshore blockers, the ultimate investment is

being made by the hedge funds themselves that are still here in the United States largely. I can try to see if we have that information for our membership, and I would be happy to supply it to you.

Mr. VAN HOLLEN. Okay.

Ms. MCDOWELL. Mr. Van Hollen, in my testimony I made reference to an exception that is in current law for debt-financed real estate investments made by pension funds and by colleges and universities, and I suggested that that exception might serve as a model for an expanded exception that would apply to all types of debt-financed property and be available to all types of tax-exempt organizations.

The real estate exception has two types of restrictions. One set of restrictions appies to all debt-financed real estate transactions, and is directed at the sale leaseback type of transaction that was the target of the debt-financed income rules. So, for example, these restrictions prohibit seller financing, they prohibit contingent debt, they prohibit a leaseback of the property, all the types of things that were found in what is referred to as the Clay Brown transaction for the Supreme Court case that upheld that type of transaction.

There is a second set of rules that deal with real estate investments made through partnerships. The potential abuse in partnerships is different than the sale leaseback—well, in some ways it is the same but the primary focus for partnerships is that they create an opportunity for tax-exempt partners to transfer tax benefits to taxable partners because being tax exempt, the tax-exempt partners are neutral about whether they receive income or losses for tax purposes. The rules in the Code today I must say are horrendously complex. The rule referred to as the "fractions rule" has been said to complicate even the most straightforward transactions. I am not suggesting that that rule be applied to non-real estate transactions. It is very much tailored to real estate. What I suggested is that Congress give Treasury regulatory authority so that if there are abuses of this sort, Treasury could then promulgate regulations. As far as I am aware, hedge funds are not used for the purpose of transferring tax benefits from tax-exempt investors to taxable investors but my understanding is based on a couple of inquiries, not on a thorough study. So, that is something that I think the Committee would want to be aware of as a potential issue.

Mr. VAN HOLLEN. Okay, thank you very much.

Mr. SHAPIRO. May I just add a potential analogy that might encourage you to follow this line because I think that the idea of—and this is not MFA talking, this is a personal view as a lawyer in this industry, the idea of allowing tax-exempts to invest their money in debts and securities where they are not controlling the leverage, it is done by a separate manager——

Mr. VAN HOLLEN. Right.

Mr. SHAPIRO [continuing]. Reminds me of what happened with regard to the rule that I referred to before. In 1966, this Congress said, "We want foreign investors through the Foreign Investors Tax Act to invest without taxation in the United States." However, they said then that the principal office of the foreign investor, if it was a corporation, had to be offshore and that led to a whole industry of administrators and directors and accountants and everybody

doing things in the Cayman Islands and the Netherlands. About 12 or 13 years ago, someone finally woke up and said, "This is ridiculous. We do not want to charge these people taxes. We want them all to invest in the United States." So, the rule which was changed, no need to have a principal office offshore. Indeed, we are encouraging you to have your employees, your administrators, your directors, all of your administration in addition to the management go on in the United States. There has been no abuse at all, and there has been a huge move of administrators and business to the United States away from the Caribbean Islands. I think there is some analogy here, as you said, and you could define it tightly so that it did not involve tax-exempt entities going out and doing their own leverage but if you said to the tax-exempt entities, "We want you to invest. We just as soon be having you invest here in the United States with managers so you do not have to go offshore." I do not think if it was done correctly that there would be a huge abuse and it would follow the very good precedent of eliminating the principal office rule, which was there primarily to protect revenue, but I think everybody recognized that it was not necessary.

Mr. VAN HOLLEN. Thank you. Thank you all. Thank you, Mr. Chairman.

Mr. NEAL. I thank the gentleman. The gentleman from New York, Mr. Crowley, is recognized to inquire.

Mr. CROWLEY. I thank my friend from Massachusetts for yielding the time. Let me just make a couple of comments before I ask my question and that is some of my colleagues on the other side have made reference to the fact that—or at least one colleague has made reference to the fact that in his opinion that this is a "stealth tax," the AMT, that somehow making one, like myself, to believe we did not see this coming. The truth be known, we have seen this coming for quite some time, and I would just remind my colleagues on this side of the aisle, for at least the previous 6 years, prior to the beginning of this year, they have controlled both the House, the Senate and the White House and really took very few steps I think to correct the problem of the AMT. Although we can all throw stones back and forth again at each other in each party, over the years since the assumption of the AMT, I think it is important to make that note, that at best there has been neglect and we have not done enough over the last 6 years. In my opinion, we have actually contributed, this Congress and this administration have contributed in creating even a greater problem to what I think are irresponsible tax cuts for some of the wealthiest in this country.

Having said that, let me just move, and if the Committee will just abide my moving from this issue for just a moment and focusing on another issue of grave concern I think to the nation as well as pertains to the subprime mortgage industry in the United States. I would specifically direct my question to Mr. Metzger and Mr. Shapiro. As hedge fund operators or managers, did either of your entities purchase mortgage-backed securities or collateralized debt obligations or other mortgage-related securities?

Mr. SHAPIRO. I am sure some of the hedge funds that we represent did, yes.

Mr. CROWLEY. Mr. Metzger.

Mr. METZGER. I do not know the answer to your question. I can say that I left the hedge fund 18 months ago so I do not know what has been in the portfolio the last 18 months.

Mr. CROWLEY. Well, I imagine prior to 18 months ago, there was some involvement——

Mr. METZGER. I do not know the answer but it is reasonable to assume that there were.

Mr. CROWLEY. There probably were. You can answer in an assumed fashion if you like as well, Mr. Metzger.

[Laughter.]

Mr. CROWLEY. I will get a more pointed and direct answer from Mr. Shapiro. Do you feel as though your entity received the appropriate information that there were appropriate avenues for knowing what was entailed in those CDOs?

Mr. SHAPIRO. This is a complicated question that I did not prepare to answer.

Mr. CROWLEY. I understand. I am also not here to put you on the spot.

Mr. SHAPIRO. Not on behalf of a MFA, it is just a reaction, I think there were mistakes made all along the way in the subprime area by the investment bankers, by the mortgage bankers who did the loans, by the rating agencies, by almost everybody and obviously Congress is going to think about what it can do to help prevent that problem from happening in the future. A lot of very smart people missed signs that a few very smart people saw. What could be done better, I think that everybody who has been affected by this is going to take steps to now be sure that the investors and the people who package these loans and the people who borrow money who probably should not have been borrowing on the same terms are all on notice with much more transparency about the transactions and much more thought given to the risks of the whole securitization effort. It does not mean in my view that securitization is a bad thing. Quite the contrary, it is a wonderful new technique for financing transactions and I think it assists the economy and the banks because other sources of funds are there but a lot of questions have to be asked about how carefully it has to be put together.

Mr. CROWLEY. So, it is really a question of transparency as far as you are concerned?

Mr. SHAPIRO. Well, I think transparency is very important and maybe more due diligence and also an understanding that in these transactions, if there is a small part of a securitization that can be tainted because it is not secure, it can affect the whole transaction.

Mr. CROWLEY. Are you suggesting that bank securities and credit rating agencies need more regulation?

Mr. SHAPIRO. I am not suggesting that, I think that that is probably something inevitably that one Committee or another is going to look at. I do not think necessarily regulation as opposed to self-review of their procedures is the answer. I really do not know the answer.

Mr. CROWLEY. Self-review of their procedures is how we got into this predicament I think in the first place.

Mr. SHAPIRO. Well, that is something that I think—that I am sure you will be talking about.

Mr. CROWLEY. Mr. Metzger.

Mr. METZGER. With regard to credit risk, my understanding is that many of the funds marked—not to market but—to rating those investments and since they were rated triple A, they were marked at par.

Mr. CROWLEY. Clearly had deficiencies in terms of triple A, they were triple D probably or components thereof?

Mr. METZGER. I do not know what was in the portfolios but I assume that with regard to credit risk if the funds are relying on marking to rating, if the rating was incorrect, the valuation was incorrect.

Mr. CROWLEY. Thank you. I yield back. Thank you.

Mr. NEAL. I thank the gentleman. The gentleman from Alabama, Mr. Davis, is recognized to inquire.

Mr. DAVIS. Thank you, Mr. Chairman. Mr. Metzger or Mr. Shapiro, let me go back to the line of questions that Mr. Emanuel and Mr. Pascrell pursued earlier. Both of them were asking you about the underlying inequities or equities with respect to the deferred compensation for hedge fund managers, and I think both of you made a similar point. Both of you indicated that deferred compensation is a fairly regular feature in at least some aspects of our economy, particularly for high-end wage earners. I want to make sure you got the point that they made in response, and I suppose everyone else in the room got this point. Yes, it is true that deferred compensation is a feature of our economy, the point that they were making is that there is a very limited number of individuals for whom deferred compensation is the heart of how they get paid. That would be a very narrow class of people, a very limited class of people making very large incomes. To put this in perspective, I certainly would not be bold enough to ask either of you your incomes, that is between you and the IRS, but can you give—either one of you give me some sense of the average amounts of money that hedge fund managers make in a particular year just from your anecdotal experience, what kinds of compensation are we talking about, what kinds of income are we talking about, either of you?

Mr. SHAPIRO. Do you want me to start? These are not figures that one has to go too far to find because it has become common lore in tons of magazines how much hedge fund managers make.

Mr. DAVIS. But would you give me just some of those numbers?

Mr. SHAPIRO. Millions of dollars.

Mr. DAVIS. What is the largest hedge fund income level that you all are aware of just from your anecdotal experience, what is the highest amount of money you have heard of anybody making as a hedge fund manager?

Mr. METZGER. There was an article, it was a front page article in the New York Times a couple of months back that quoted from—I do not recall which—hedge fund publication that listed the top 20 or 25 paid managers, that information is in the public domain. I do not recall it at this point.

Mr. DAVIS. Well, I understand that but both of you were involved in the industry, would one of you care to give me just some numbers that you saw on that list just so we can put it in perspective? Are both of you telling me you cannot give me a single number the hedge fund managers make?

Mr. SHAPIRO. I think that there probably were a few managers who made well over $500 million.

Mr. DAVIS. Okay, a few who made well over $500 million. A substantial number who made over $100 million from your perspective, from what you know of the industry? You are both nodding your heads, you are nodding your head, yes, Mr. Metzger.

Mr. METZGER. Yes.

Mr. DAVIS. You would agree, Mr. Shapiro?

Mr. SHAPIRO. Last year, yes.

Mr. DAVIS. Alright, now, since my time is limited, let me tell you why I make this point. You know about the PAYGO rules that this institution passed, you know it is a response to years of spiraling deficits and spiraling debt. In effect, every new expenditure we make under these rules, we have to now behave as most American families do, either we have to raise new revenue or cut spending in some place. So, we have to make a constant set of political and moral choices about how to pay for things, just as most families do. We could have no doubt a very interesting, if somewhat esoteric, economic argument about the relative benefits of deferred compensation for hedge fund managers or the relative incentive or dis-incentivizing consequences or particular tax treatment but ultimately this Congress has to decide if we are going to fix AMT, how do we do it, and we have to make a decision what are the most equitable set of pay-for's that we could bring to the table. The point that I think you hear from some of my colleagues on this side of the aisle is that if we have to engage in the very important work of providing tax relief from any middle income Americans, frankly it makes sense for the pay-for to aim at individuals who are making massive amounts of money, who frankly will not really miss the difference. If we have to choose, well, we are going to change the tax structure from 15 percent to 35 percent for someone making $100 million per hedge fund, well, that may be much more defensible to the people we represent. By contrast, a few years ago, the old majority in Congress was trying to figure out a way to pay for the cost of Katrina reconstruction and they made a very interesting decision, to go to 13 million families on Medicaid and say for the first time, you have got to do a co-pay if you take your kid to a doctor. By definition, those families were making between $28,000 and $40,000 a year—between $14,000, I am sorry, and $40,000 a year, so that is the framework for this argument, that some of us on this side of the aisle believe if government has to demand extra revenue from anyone, that you logically do it from people who may be in the $100 to $500 million range. That is what this debate is really about.

I yield back.

Mr. NEAL. Thank the gentleman. The gentleman from California, Mr. Thompson, is recognized for inquiry.

Mr. THOMPSON. Thank you, Mr. Chairman. If I could just follow on Mr. Davis' line of questioning, maybe Mr. Shay you could tell me, as are trying to figure out how to achieve international tax reform and recognizing the fairness and equity issue, as Mr. Davis pointed out, are there a set of principles or recommendations that you would make as to what we should—how we should go about

considering international tax reform, are there things that we should or should not try and do?

Mr. SHAY. Well, as I outline in my testimony, the current rules have a series of exceptions or incentives that in essence encourage investment outside of the United States in lower tax jurisdictions. The one unique issue about international taxation is it does involve other countries, it is not all within one economy. Taking that into account, I still think that there is a substantial scope to restrict some of those benefits for foreign investment as to cut back on them to raise revenue without adversely affecting the ability of us to compete in the world. They basically include restricting the current scope for deferral of U.S. taxation on U.S. persons' foreign income earned through foreign corporations. While I am a real believer in the foreign tax credit to the point of eliminating double taxation so we do not discourage international investment, our rules now go further than that and actually encourage foreign investments, so I would also support changes to the foreign tax credit really through the source rules—this is starting to get technical—that would not result in there being more foreign tax credits say than there would be even if we exempted foreign income, which comes back to the point I made in my testimony. I think that is responsive to your question, sir.

Mr. THOMPSON. Thank you very much. Ms. Gallagher, would tax-exempt investors invest in onshore hedge funds rather than offshore hedge funds if the debt-financed income rules did not apply to the hedge fund investments?

Ms. GALLAGHER. Yes, sir, the only reason that people go offshore is to avoid the application of the section 514 rules.

Mr. THOMPSON. So, it is just a straight tax avoidance issue?

Ms. GALLAGHER. Again, as we said earlier, we do not think the section 514 rules were intended to cover this kind of investment, by using offshore blockers, foundations and other tax-exempt entities are able to avoid the application of that tax and the Internal Revenue Service has issued several rulings acknowledging that that is the case.

Mr. THOMPSON. Thank you.

Ms. GALLAGHER. But if you take away the rules, then you take away the reason to go offshore.

Mr. THOMPSON. Thank you.

Mr. SHAPIRO. May I add something?

Mr. THOMPSON. Yes, sir. You are going to need to speak directly in the microphone. It is very hard to hear on this end of the dais.

Mr. SHAPIRO. You are not hearing me? Okay. If tax-exempt entities invested in the U.S. partnerships and did not have the debt-financed income rules, they would actually be ahead of the game in this respect: when they go offshore, which they do legitimately to avoid what we all think is not the right application of the debt-financed income rules, the offshore entities they invest in are subject to 30 percent withholding tax on all the dividends those offshore entities earn whereas if they were invested in a partnership here, they would have zero tax to pay. They would not have the 30 percent withholding tax. So, tax-exempt entities are actually hurt by having to go offshore to avoid the debt-financed income

problem by being in entities that are subject to 30 percent withholding tax on dividends. So, it would be an advantage to tax-exempt entities to bring them back onshore rather than forcing them to stay offshore.

Mr. THOMPSON. Somebody is shaking their head, are you in agreement with this? Ms. Gallagher.

Ms. GALLAGHER. I am sorry, I was shaking my head at the gentleman behind me.

Mr. THOMPSON. It is not hard to confuse me.

Ms. GALLAGHER. It is my understanding that the offshore hedge funds are largely structured to avoid the dividend withholding but I am being told I am wrong about that.

Mr. THOMPSON. Could we somehow get some clarification on that, Mr. Chairman?

Mr. METZGER. I was also shaking my head in agreement with Mr. Shapiro.

Mr. THOMPSON. Thank you. I yield back, Mr. Chairman.

Mr. NEAL. I thank the gentleman. All Members of the Committee now have had an opportunity to inquire of at least one panel so now we are going to return to the regular order, and I would remind Members of the Committee that we still have two more panels to go. By way of discussion with Mr. McCrery, we would hope that Members of the Committee might consider 3 minutes of inquiry time rather than five. We will now move to other side. Mr. English, the gentleman from Pennsylvania, will inquire.

Mr. ENGLISH. Thank you, Mr. Chairman. Mr. Metzger, in your testimony, you state that proposals to raise revenue to pay for an AMT reform bill by imposing taxes on pension funds invested offshore will hurt many of the very people the AMT is supposed to help. Can you extrapolate on that for us?

Mr. METZGER. Yes, on May 16, 2007, the New York Times reported that Congress is considering closing the "Loophole" that allows tax-exempt investors to avoid paying taxes on their hedge funds investments. Students at NYU have suggested that if you tax the tax-exempt investors that make offshore investments, many of the beneficiaries of those pension plans are middle-class taxpayers. So, if Congress tries to pay for the AMT by taxing tax-exempts, effectively you are taking money out of one pocket and putting it in the other pocket.

Mr. ENGLISH. Following up on that, Mr. Metzger, would you explain for us what you meant in your written statement when you said, and I quote: "Singling out specific industries for special adverse tax legislation would be poor public policy"?

Mr. METZGER. I think if there is an issue such as deferral, you ought to tax everyone's deferral. If there is an issue such as carried interest, you should not be singling out industries. In terms of public policy, the best way to solve a problem is not to enact what I will call a "windfall profits tax" but deal with the economic issues, deal with the policy issue.

Mr. ENGLISH. So, in other words, equity issues when dealing in the real world of international tax policy are sometimes a little complicated. On that point, Mr. Shay, I noticed that you made a number of points about fairness in your testimony. I take it you

strongly support the current U.S. system of territoriality in the taxation of foreign income, is that a fair summary?

Mr. SHAY. Actually, sir, the U.S. currently does not impose territoriality in the way it is conventionally thought of.

Mr. ENGLISH. That is correct.

Mr. SHAY. I am not a supporter of territoriality.

Mr. ENGLISH. You are not. Are you familiar with the Homeland Re-investment Act that Congress passed a couple of years ago that created a 1 year window for repatriation of foreign earnings into the U.S.?

Mr. SHAY. I am very familiar with it.

Mr. ENGLISH. Are you familiar with how much money was brought back that would have otherwise been stranded offshore by that Act?

Mr. SHAY. I do not have a specific number.

Mr. ENGLISH. Does $350 billion sound about right?

Mr. SHAY. It is somewhere in that range, that is correct.

Mr. ENGLISH. That money would have never made it into the United States otherwise, would you concur with that?

Mr. SHAY. No, but I do think——

Mr. ENGLISH. You do not?

Mr. SHAY. Some of the money would have come back but it is fair to say that that accelerated the repatriation of money but the question really is did that have—that legislation was billed as having an economic impact.

Mr. ENGLISH. You deny that?

Mr. SHAY. What is not clear to me at all is the ultimate economic effect of money going from one pocket of the corporation to the other pocket of the corporation.

Mr. ENGLISH. Well, I am out of time, Mr. Chairman, but I would be delighted to share with Mr. Shay some of the studies that have shown the economic growth that has sprung from that. I thank you very much.

Mr. NEAL. I thank the gentleman. The Chair recognizes the gentleman from Michigan, Mr. Levin, to inquire.

Mr. LEVIN OF MICHIGAN. Thank you and thanks to all of you. This has been a really useful hearing. They are long but necessary, and I think very helpful. On the UBIT issue, I think the testimony has been very succinct and a number of us have asked questions about it. We have been working on this issue for some time relating to the tax-exempt entities in the UBIT rules and there is legislation now ready to be introduced I hope today that would address this issue. So, you have reinforced I think the need for there to be such legislation, and I would urge all of my colleagues to look at this legislation and see if they would like to join in.

Secondly, I think it has been useful regarding retirement systems, and there is a letter that was sent out yesterday from the National Conference on Public Employment Retirement Systems and it says the following, and I would like, Mr. Chairman, for it to be entered into the record, this letter.

Mr. NEAL. Without objection.

[The provided material follows:]

National Conference on
Public Employee Retirement Systems
The Voice for Public Pensions

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August 24, 2007

The Honorable Charles B. Rangel
Chairman, Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

The Honorable Jim McCrery
Ranking Member, Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

Dear Mr. Chairman and Ranking Member McCrery:

The National Conference on Public Employee Retirement Systems (NCPERS) is the largest national, nonprofit public pension advocate. For more than 65 years, we have been the principal trade association working to protect the pensions of America's public employees.

I write on legislation now before Congress that could have enormous negative impacts on the economy, public pension funds, and the many public employees who depend on defined benefit pensions for their retirement security. At a time when the markets and our economy seem to be struggling, S. 1624 and H.R. 2834 could conceivably intensify the volatility now roiling the equities markets.

Both of these tax proposals target pension funds by substantially raising taxes on private equity funds. It is unreasonable to think that increasing the tax burden on private equity funds will not be borne, in some measure, by the pension funds who today benefit from the industry's performance. And, to compensate for this, pension plan sponsors will be forced to make up the difference by increasing pension contributions or allowing the unfunded liabilities of public pension plans to increase.

Private equity investment returns have provided billions of dollars of investment profit for pension plans, and these gains have helped support the stability of public retirement plans across the nation, relieving taxpayers of some of that burden. In fact, nearly three-quarters of public pension plan assets are the result of investment returns. The proposals in Congress will undercut these returns to the pension funds that benefit workers and retirees.

On behalf of more than 500 public pension funds representing nearly $3 trillion in assets, we remind you of the pension beneficiaries who will bear the burden of these tax increases: your state's first responders, firefighters, police officers, teachers,

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State, county and municipal employees, and members of the judicial system—in short, all of the public employees who serve the citizens of your state.

It is important to note that eighty percent of the profits from private equity investments go to the limited partners, investors like our pension funds. Public pension funds invest in private equity to meet the long-term commitments to employees who retire after their many years of public service. Most pension fund managers will tell you that they do this because private equity has provided significantly better returns than publicly traded equities have.

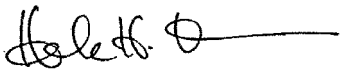
Between 1980 and 2005, the top-quartile private equity firms delivered 39.1 percent annualized net returns, significantly beating the S&P 500 and other public market indices. Those superior returns helped strengthen public pension funds and defined benefit retirement plans for our members across the country.

We consider it our duty to state our opposition to S. 1624 and H.R. 2834. NCPERS does not believe that your intent with these tax bills it to jeopardize the pension plans of the many dedicated, hardworking public employees you represent. Unfortunately, that will likely be the result, should these bills become law.

In closing, we request that you carefully consider the impact that both of these bills or any similar legislative action increasing taxes on private equity will have on pensions. The impact is real and potentially great.

I would be pleased to answer any questions you may have regarding our position. I can be contacted at (202) 624-1456 or at hank@NCPERS.org.

Sincerely,



Hank H. Kim, Esq.
Executive Director & Counsel

cc: Members of the Committee on Ways and Means

Mr. LEVIN OF MICHIGAN. It states: "While some of our members feel that the bills," they are talking about the carried interest bills, "could affect the public planned community, the majority of our members do not share that opinion." I think Mr. Cantor was here when that was raised.

Thirdly, I would like to say to you, Mr. Shapiro, we welcome your candor. You spoke, and I hope Mr. Cantor will hear this now or later, you were asked a series of questions and you gave a series of answers that the person who asked the question I think did not find particularly felicitous. But I hope that as we go forth on these issues, that we will ask questions and will listen to the answers. That is why we are having these hearings, to have an intelligent, open discussion about this issue, including the carried interest issue. I do think that your response was not what some wanted to hear, and I do not want to over-characterize it, it was very direct, but that is what we need to hear. We need to get straight answers to these important questions, and this panel I think has been especially helpful.

I finish with this, the question Mr. English asked about this repatriation, I would like to see the studies that show that this elimination of taxes in the multi-, multi-billions really paid off in terms of new jobs in this country because I think the evidence is overwhelming that that was not true and that the provision that there be a job creation result was something that was hard to trace and to the extent it has, it turned out to be incorrect.

But, again, I want to thank you for your straightforward testimony. We are ready on this UBIT bill and I hope to have it introduced today, and I ask all of you to join in if you would like to. Thank you.

Mr. NEAL. The Chair is going to move away from the previous commitment only because the gentle lady from Nevada has not had an opportunity to inquire. She has asked that she be allowed to offer her first inquiry. The Chair recognizes the gentle lady from Nevada.

Ms. BERKLEY. "Nevada" but thank you.

[Laughter.]

Mr. NEAL. I am from Massachusetts.

Mr. LEVIN OF MICHIGAN. How do you pronounce Massachusetts?

Ms. BERKLEY. How do I? Las Vegas. Thank you very much for being here. This has been most informative. I am new to the Committee and there is not a day that goes by, particularly today, that I did not wish I paid better attention to my tax professor in law school, it would have made my life a whole lot easier now. You have a wealth of information, and I am delighted that you are sharing it with us. The one thing I have that you do not is a vote, and somehow I am going to have to vote when all of this over on how we are going to have the requisite amount of revenue that we need for the needs that my constituents tell me that they are in need of.

A couple of years ago, about 3,100 of the people that live in Las Vegas that I represent paid the AMT and in the neighboring congressional district, there were about 6,300 that were subject to the AMT. The next year, they do not know this yet, but there is going

to be 30,000 people that are going to be subject to the AMT in my congressional district and in the neighboring congressional district, approximately 55,000.

Now, I do not think the question is—I do not have a voracious appetite to tax anybody and I ask my constituents when they come and see me and when they come to Washington to talk to their Member of Congress and they sit in my office, if it is the people representing the police departments, they want additional funding to hire more police or to get better communication systems. If it is the firefighters, they want more equipment to be able to fight the fires in the western United States. Parents that come to me want to make sure that their kids keep getting a good education. My seniors that come and visit me, AARP and all the others, want to make sure their Social Security is going to be here when they retire and their Medicare is going to be there and transportation issues. We do not want to have another disaster like we had with the bridge in Minnesota, and for a district like mine, where we are laying as much concrete and pavement as we can to accommodate the 5,000 new residents I have a month coming into my congressional district, the costs of keeping up with that are extraordinary.

So, in the earlier panel, the first panel, they told us that their best advice is to get rid of the AMT, just get rid of it and that is going to cost us over $600 billion over the next 10 years. I have to come up with a way because of the PAYGO rules to offset that. If you were sitting here instead of there, and I had paid better attention in law school so I would be sitting where you are, what would you recommend that we do? Where do we get that revenue if we are going to do the AMT fix for people that never should have been ensnared in the AMT in the first place? Anybody? Thank you, Mr. Metzger.

Mr. METZGER. I believe that Dr. Burman stated in the last panel that he felt that he did not see much benefit to preferential long-term capital-gains rates. That is a starting point.

Ms. BERKLEY. How much revenue would that bring in?

Mr. METZGER. How much revenue would be brought in? I do not know.

Ms. BERKLEY. Me neither.

Mr. METZGER. I do not know because I believe a lot of the trading tax-exempt today, a lot of trading done is actually done by institutional investors that are tax-exempt so actually I do not know how much would be raised but that is at least a place at which to look.

Ms. BERKLEY. Mr. Shapiro.

Mr. SHAPIRO. I do not know, I really think that frankly we are sympathetic to the dilemma, I think most of us are because we are U.S. citizens and we want to see equity and fairness. I think rather than targeting any one industry or one loophole or one issue that people have identified, that one would go back and see whether the rate reductions that took place some years ago should be re-visited to see if a small rate reduction across the board can raise enough of the revenue to meet the $600 million or whatever the number is.

Ms. BERKLEY. Billion.

Mr. SHAPIRO. I do not have the answer.

Ms. BERKLEY. Thank you. Thank you, Mr. Chairman.

Mr. NEAL. I thank the gentle lady. The gentleman from Washington, Mr. McDermott, is recognized to inquire.

Mr. MCDERMOTT. Thank you, Mr. Chairman. I want to ask a question for a bricklayer in my district who is used to being paid wages at the end of the month and being taxed under the IRS. Mr. Metzger, you state that hedge fund managers will likely defer compensation when they manage offshore funds and receive carried interest when they manage onshore funds. Now, it seems to me that is very often managing the same pool of money, and I would like you to explain to my constituents because I am going to have to, why is one payment, carried interest, taxed at capital gains rates, 15 percent, and the other is taxed—the deferred management fees are taxed as ordinary income, what justification is there for that? Why should my taxpayer have to pay the higher rates and a manager can play these games and get this break?

Mr. METZGER. That is an excellent question and before I address it, I just want to correct the record in that a carried interest is not taxed necessarily at 15 percent.

Mr. MCDERMOTT. What is it taxed at?

Mr. METZGER. It depends on the source of income. As I said in my testimony, a lot of the income, in fact in my experience, the majority of the income, is taxed at ordinary rates. Carried interest means that the adviser, or hedge fund manager, shares in all the tax attributes. So, for example, if only 35 percent of the taxable income is preferential-rate income, a 15-percent tax would apply to the 35 percent but the remaining 65 percent of income would be taxed at ordinary rates at 35 percent. In my experience, most of the hedge fund income is not preferential. So, I just wanted to——

Mr. MCDERMOTT. So, are you saying this problem does not exist, that it is a fair system, there is really nothing here to be looked at?

Mr. METZGER. No, no, I am going to get to your question in a moment.

Mr. MCDERMOTT. Okay.

Mr. METZGER. I just wanted to make sure that you did not have this idea that all of the carried interest in hedge funds was taxed at 15 percent. Now that might be different from private equity but that is not my area of expertise.

But in terms of your question, what I think you are saying is the hedge fund adviser does the trading at the master-fund level and receives his or her compensation at the feeder level, and I think what you are saying is that the managers can choose, let's say I want to treat it as service income, so I will say if I receive it at the offshore level, it is a service income. If I receive it at the onshore level, no, that is a carried interest. I think that is your question. I do not think you will like my answer, however there is a difference and that liquidity—if a manager wants liquidity, the manager will choose to take compensation as a carried interest. If the manager says, "I do not need the money for 5 years or 10 years," the manager will choose deferral. That said, the tax law, the Tax Code permits taxpayers to, if you will, choose how they structure their compensation arrangements.

Mr. MCDERMOTT. But how can it be fair if my bricklayer can only put $20,000 into his IRA and these managers you are talking about can put a half a billion dollars into essentially an unofficial IRA that is holding out there until some day they decide to bring it back in, what is the fairness in that? Why do you not let me put all I can put in as a bricklayer?

Mr. METZGER. Again, that is what the Tax Code allows and they are following the Tax Code. If your question is should the Tax Code be changed, if that is what your question is, my answer is all types of deferred income should be treated the same way. You should attack the issue instead of attacking particular industries. Today the hedge fund industry is successful, if we had this hearing 10 years ago, you would not have been talking about hedge fund managers. Five years from now it may be a different industry. Instead of singling out industries, which is a quick fix, why do we not just attack the issue of deferrals entirely?

Mr. MCDERMOTT. Thank you. Thank you, Mr. Chairman.

Mr. NEAL. I would like to yield for a moment to the Republican leader, Mr. McCrery, for an unanimous consent request.

Mr. MCCRERY. Thank you, Mr. Chairman. A few minutes ago, our colleague from Michigan, Mr. Levin, introduced for the record a letter from the National Conference on Public Employee Retirement Systems. That letter was a follow-up to an earlier letter, dated August 24, 2007, from the same National Conference of Public Employee Retirement Systems, and I would like to submit for the record that August 24th letter so that both of these can be read together.

Mr. LEVIN OF MICHIGAN. Reserving the right to object, I do not at all, I just urge that everybody read in that letter we argue that the bills could potentially have a negative impact on public pension plans, the position we took is not the view of NCPERS' full membership and that the majority do not agree with the letter that was sent earlier. I am glad to have both in.

Mr. MCCRERY. I think it would do Members well to read both letters. They can judge for themselves the merit of each letter.

Mr. LEVIN OF MICHIGAN. No, no, I fully agree. I hope they will read both of them. I withdraw my reservation.

Mr. NEAL. Just before the Chair recognizes the gentleman from Georgia, maybe all the members might want to think about the possibility of doing what we did between the first and second panels where we allowed members of the first panel who had not been able to participate in inquiry to become first in line for questioning the next panel, just a thought as we move to Mr. Lewis.—The gentleman from Georgia is recognized to inquire.

Mr. LEWIS OF GEORGIA. Thank you very much, Mr. Chairman. Let me thank the members of the panel for being here today. I know it's been very long for you, like it's been long for many of us. But we live in a complex world, unbelievable world.

We live in a country with a sophisticated economy, and so some people believe, therefore, we should have a complicated and sophisticated tax pool. So, I want to ask you, would you agree that the international tax rule on hedge fund investment off-shore are unnecessarily complicated and the effect of making the Code less fair?

If one of you could make only one change to our international tax law, what would it be? What would it be? Anybody.

Mr. SHAPIRO. I haven't thought about it before and this is my personal view, but we talked before and I made the suggestion that trying to simplify the rules to allow this huge and wonderful, important tax exempt community that represents such great missions to invest their money in U.S. funds without being subject to tax to me would simplify a significant amount of the planning that goes into hedge funds.

So, I think that suggestion was made over here and I think it would be a very interesting idea for you to pursue. It would be consistent with some very smart decisions made by this congress going back to 1966. Let's encourage foreign investment, and then 20 years later, let's get rid of any rules that require them to have sort of artificial, off-shore offices. Let's encourage the money to be managed here on a favored tax basis. I think that would be one of a number of steps that you could take to simplify the tax law as it applies to hedge funds.

Mr. LEWIS OF GEORGIA. Thank you. Other volunteers?

Mr. SHAY. Mr. Lewis, I mentioned a couple of proposals in my testimony, but the one that would probably have the greatest simplifying effect would be to not have deferral of taxation on foreign corporate earnings in terms of reducing some of the complexity that's in the Code.

Mr. LEWIS OF GEORGIA. Yes?

Ms. MCDOWELL. Mr. Lewis, this does not go to international tax overall. That's not my area of expertise. My area of expertise is tax exempt organizations. However, I think that enlarging the exception to the debt-financed income rules so that most debt-financed transactions could go forward without regard to those rules would greatly simplify investments for charitable enterprises.

Mr. LEWIS OF GEORGIA. Thank you very much. Thank you, Mr. Chairman. I yield back. My time is up.

Mr. NEAL. I thank the gentleman. I believe the gentleman from California, Mr. Becerra, would like to inquire.

Mr. BECERRA. Yes, Mr. Chairman. Thank you very much, and I thank the panel for their patience as we go through all the questioning, but we do appreciate your comments.

Ms. McDowell, let me ask a quick question. You just mentioned that you thought we should perhaps examine the debt finance income rule so that we could make it perhaps a fairer process for a lot of our not-for-profit entities that are going offshore.

What if we were to say that we want to provide an equal playing field by saying that we'll apply the UBIT tax to offshore investments versus not apply the UBIT tax to onshore investments?

Ms. MCDOWELL. Well, in my judgment we're talking here about one part of the UBIT tax. We're talking about the part that applies to debt-financed investments. I don't see a reason to discourage debt-financed investments across the board. The current rules were enacted in 1969 to respond to a very specific abusive transaction, a sale lease back transaction. They've done that successfully, and I think that there are rules that are in the Code now that deal with real estate transactions that would continue to do that.

Mr. BECERRA. I sense what you're saying. I think there's a threat of reasoning in what you're saying. You're saying that if we actually expanded the debt finance rule under the UBIT tax to offshore investments, what you'd in essence do is kill those debt-financed investments.

Ms. MCDOWELL. Right, and I don't think there's anything wrong with many of them.

Mr. BECERRA. Okay, great. I appreciate that answer. Let me ask Mr. Metzger. I think you've been asked this question somewhat, but I want to make sure I'm clear on this. I'm a fund manager, and I'm making investments onshore. I suspect my investors are expecting me to do certain things to invest that money wisely to create a good return. I am now a fund manager for an investment that's offshore. I expect that those same investors, whether they are now corporate shareholders or whether they were limited partners in the onshore investment, are expecting the same type of wise investment and similarly high returns.

Correct?

Mr. METZGER. Yes.

Mr. BECERRA. Does one fund manager behave differently from the other fund manager if it's an onshore or offshore investment?

Mr. METZGER. Now, you're talking about two side-by-side investments, or are you talking about the classic, master-feeder arrangement?

Mr. BECERRA. It's two different individuals. Do they try to behave similarly whether it's an onshore or offshore investment and to try to extract as much return for that investment as possible?

Mr. METZGER. If I understand your question correctly, you're asking me, if you have, for example, onshore investors, and offshore investors, do they have different interests. The answer is yes. So, for example, the onshore investor prefers to receive preferential-rate dividend income. The offshore investor prefers that fund does not receive dividend income that is subject to withheld tax.

Mr. BECERRA. No, I understand that.

Mr. METZGER. So, therefore the manager of the offshore fund might try to use derivative financial instruments to avoid paying the tax. So, there might be slightly different trades.

Mr. BECERRA. Let me try to approach it a little differently, because I understand what you've said, and I agree with you. I know my time has expired so I want to try to close on this.

Say I have investors here onshore who wish to invest. I want to then calculate how to make the best investment based on their circumstance, tax-wise and otherwise. I am now approached by some folks who want to keep the money offshore. I then have to make those calculations based on their circumstances.

If I've done a great job of investing in my history in my career, is there any reason why an investor would not want to approach me simply because of the investment being offshore or onshore?

Mr. METZGER. Oh, if you're saying would a U.S. investor perhaps not want to invest in an offshore fund?

Mr. BECERRA. No.

Mr. METZGER. I'm not following the question.

Mr. BECERRA. Me, the individual; me the fund manager; I'm asking about the individual. I'm being judged on my capabilities to

invest the moneys, whether it's an offshore or onshore investment. Correct?

Mr. METZGER. Yes.

Mr. BECERRA. Okay. I know there are different types of investments you would make based on an offshore, onshore investment. But if I'm a good fund manager, I'm capable of making investments for an onshore fund or an offshore based fund.

Mr. METZGER. Yes.

Mr. BECERRA. So, based on that then the final question is and similar to the question that was asked earlier, is there a reason to distinguish how we categorize the compensation received by me as a fund manager, simply because in one instance I'm making investment decisions for an onshore fund. In another situation I'm making decisions for an offshore based fund.

Mr. METZGER. So the distinction is that for the investment in the onshore fund is, the advisers your compensation is more liquid, and the Internal Revenue Code tells you how to treat that income.

If the investment is in the offshore fund and the advisor chooses not to receive it in a liquid form, the adviser follows the Internal Revenue Code. Economically, the activity is the same. Economically the income is the same. But because the Code allows the adviser to classify one as liquid and the other as illiquid, they have different tax treatments.

Mr. BECERRA. I'll decipher what you've just said in terms of liquid versus not and trying to navigate the tax, what you're saying is you're going to try to find the best way to get your compensation at the lowest tax rate.

Mr. METZGER. Yes.

Mr. BECERRA. Thank you.

Mr. NEIL. I thank the gentleman.

The gentleman from Texas, Mr. Doggett, is recognized.

Mr. DOGGETT. Thank you very much.

I appreciate the testimony of each of you, but because of the very serious perversions of our international tax system that Mr. Shay has described today in his writings that we're blessed by this Committee in previous years, I'd like to focus specifically on that aspect and ask my questions to you, Mr. Shay.

First, I think it's important, as you voice your opinions, to make clear to my colleagues and to those who are listening, the expertise and background you bring to this issue. As I understand it, your career is based on advising multinational corporations on how they can legally minimize their taxes. Before that, you served as international tax counsel at the Treasury Department in the Reagan Administration. Is that correct?

Mr. SHAY. That's correct. My practice in recent years is probably being in addition to multinationals a lot more investment funds, because that's where the market has gone.

Mr. DOGGETT. Okay. If I understand your testimony, if I have a multinational in the United States that does business here and does business abroad, that multinational can deduct from its U.S. income for what it generated here in the United States. All the expenses that it can fairly, reasonably attribute to its foreign operations, and it can do that now. But with reference to income gen-

erated abroad, it may never be taxed on that, but certainly not until it repatriates or brings that income back to the United States.

Mr. SHAY. It is correct that you can take a current deduction say for interest and foreign corporate stock that earns foreign income that's not currently taxed.

That's correct.

Mr. DOGGETT. We'll take your expenses now but pay later on your income from abroad, and that deferral system is what much of your writing has been about. When you combine that with other inequities and what is really a swiss cheese international holes in the international tax system, like transfer pricing abuse, like a pharmaceutical company assigning a valuable patent to a subsidiary in a low tax jurisdiction, what you end up with is a significant distortion of investment decisions growing out of the tax system itself that a reasonable company would make.

Mr. SHAY. I think it's correct to say I think the current rules do encourage tax moving and shifting of particularly intangible assets. As I think you're suggesting, under current law, it is done legally. I mean, this is not something that's prohibited.

Mr. DOGGETT. When you testified to us last year, you were with a couple of fellows who said, you know, the best thing for us to do on international tax is let's not have any tax at all. Let's go to zero through what they call the territorial system on foreign source income. You don't agree with that approach.

Mr. SHAY. That's correct as reflected in my testimony.

Mr. DOGGETT. But we have learned that if you did that, given the way the current international tax system is perverted, that if we cut it to zero and let them stop this deferral of the expenses, that we'd actually generate tens of billions of dollars of income, of revenue.

Mr. SHAY. The revenue estimate that is associated with exemption, which is substantial, is partly attributed to expenses. It's also attributable to the fact that you would no longer be able to credit foreign taxes against export sales income.

Mr. DOGGETT. I should have clarified that, because you also pointed out in your paper that we essentially end up picking up effectively some of the foreign tax burden. Our taxpayers are lost to the Treasury here. Of course we actually, as you note in your paper in your testimony, we've actually experimented with doing away with taxes or almost doing away with taxes in the so-called American Jobs Act that this Committee so blissfully approved a few years ago.

Some of us would really call it the Export American Jobs Act. But under that, some of these corporations that had manipulated the tax system actually got a tax amnesty where they were able to bring back these earnings and pay at most five and a quarter percent on those earnings. Weren't they?

Mr. SHAY. That's correct.

Mr. DOGGETT. You refer to that in footnote 16 of your paper as being a farce and cite two others who found it to be a farce like an article called "The Great American Jobs Act Caper."

Mr. SHAY. I think I was citing a paper, which referred to it as a farce. I think the farce that was intended was that it was presented, I think, as an economic stimulus measure, where I think

I'd be delighted to see the studies that Mr. English has raised. It's very hard to see what the economic consequence was that was more than essentially financial shifting.

Mr. DOGGETT. Well, thank you. We can't export at greater length today, but what we had were some companies that brought back these earnings at essentially zero tax. When they consider the foreign tax credit the same day almost that they were cutting American jobs, and a situation where a company like Eli Lilly in 2004 paid an effective tax rate of 1 percent on its worldwide income, not considering this repatriated earnings.

But I just contrast that with a community pharmacy down in Buda, Texas. It's incorporated and paying 35 percent. I think that's some of the inequity that this Committee has permitted in the past that we must remedy.

Thank you very much.

Mr. NEAL. We thank the gentleman.

The gentlelady from Ohio is recognized to inquire, and I believe that we will then move to the next panel.

Ms. TUBBS-JONES. To my colleagues and friends out there; unfortunately, I've got to go back to Ohio to a funeral. So, all I want to say is I think that all of you need to help us come up with some policy that will be fair on behalf of all the taxpayers there; those at the bottom of the rung of the ladder and the upper end of the ladder.

There's got to be a little more equity to all the foundations out there. You know I'm not chairing the philanthropic caucus. I mean, we're looking for, me and my colleague are looking for opportunities to take a closer look at how you're able to raise funds for the non-profits that you're doing and the work that you're doing.

To the next panel, all the best. I hope my colleagues don't beat you up too bad and I'll see you next time around when we hit this issue.

Mr. Chairman, thanks for the opportunity to be here, and I appreciate it.

Mr. NEAL. We thank the gentlelady, and I want to thank the panelists for your patience, and certainly your sound reasoning.

Everybody offered a very good perspective, and I thought that in particular you took a very complicated matter and explained it in a manner that we could all understand.

Thank you, very, very much.

Mr. LEVIN OF MICHIGAN [presiding]. We'll now start with the third panel. We very much appreciate your patience. We're getting your names appropriately placed.

All right, Mr. McCrery, I think will begin. I believe it was suggested that we were going to have two sets of panels and that the third and fourth would come here after lunch at two o'clock. It's now four o'clock, and I think a lot of us had lunch.

But we very much appreciate your patience, and so let us introduce all of you together. Then if you go in the same order, first, and I think most of you are doctors, PhDs, Peter Orszag, who is Director of CBO.

Welcome Gene Steuerle, who also has been here many times. We welcome you back.

Actually, next to you, if we're going to go in that order, is Jack Levin, who is a partner in Kirkland & Ellis in Chicago.

Then Darryll Jones, who is a professor of law at Stetson University College of Law in Florida.

Next, Victor Fleischer, who is associate professor of law at Illinois College of Law in Champaign, Illinois.

Last, but as we often say not least, Mark Gergen, a professor of law, the University of Texas Law School, Austin.

Now, as you know, many of you have been here before. Your testimony will be placed in the record. We have the 5-minute rule. You can be assured the full testimony will be fully distributed and aired. This is just the beginning of our consideration of these issues and so everybody is not here all the time. I think you can be assured, because of the tradition and nature of this Committee, your testimony will receive the fullest consideration.

So, we'll start first with Peter Orszag, and then if we might simply go down the row, thank you.

STATEMENT OF PETER R. ORSZAG, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. ORSZAG. Thank you. Thank you very much, Mr. Levin, Mr. McCrery, other Members of the Committee. Thank you for having me this afternoon.

As you know, a growing amount of financial intermediation is occurring through private equity and hedge funds, which are typically organized as partnerships or limited liability companies and now have at least $2 Trillion under management. These organizational forms are growing rapidly for many reasons, but among the reasons is their tax treatment.

In particular, such partnerships do not pay a separate corporate income tax. Instead, they pass all income and losses through to the partners. The manner in which that income is taxed is the central focus of my written testimony. The partnerships have two types of partners, limited partners who contribute capital and general partners who manage the partnership's investments and may contribute a modest amount of capital themselves.

The general partners typically receive two types of compensation: a management fee that is tied to some percentage of assets under management and a carried interest tied to some percentage of profits generated by those assets. For example, if a fund had $1 Billion under management and the typical 2 percent management fee, management fees would amount to $20 Million a year and that amount would not depend on the performance of the underlying investments.

That $20 Million management fee is taxed as ordinary income to the general partner since it reflects compensation for services provided. If the fund also generated $150 Million in profits, the general partner with a 20 percent carried interest would receive another $30 Million. That is 20 percent of the $150 Million in profits. In practice, at least within private equity buyout firms, carried interest often applies only after a hurdle rate of return is achieved. That would change the calculations but not the underlying analytical issues involved.

Taxation on this carried interest is deferred until the profits are realized on the fund's underlying assets and are then taxed to the general partner at the capital gains tax rate to the extent that the funds underlying investments or profits reflect capital gains. So, at a capital gains tax rate of 15 percent, that $30 Million of carried interest would generate a tax liability of $4.5 Million.

From an economic perspective, a general partner in a private equity or hedge fund undertakes a fundamentally different role than that of the limited partners, because the general partner is responsible for managing the fund's assets on a day-to-day basis and the carried interest is disproportionate to financial capital invested, that is the general partner's own financial assets at risk, if any.

Most economists therefore view at least part and perhaps all of the carried interest as performance-based compensation for management services provided by the general partner, rather than a return on capital invested by that partner. That perspective would suggest taxation of at least some component of carried interest as ordinary income rather than capital gains. Almost all other performance-based compensation is effectively taxed as labor income. For example, contingent fees based on movie revenue for actors are taxed as ordinary income as are performance bonuses, most stock options and restricted stock grants.

So, too are incentive fees paid to managers of other people's investment assets where those fees are documented as such rather than in the form of carried interest in a formal partnership. Although there does not appear to be any solid analytical basis for viewing carried interest solely as a return on financial capital for the general partner, there is an analytical debate about whether it should be viewed purely as compensation for management services provided or as a mixture of compensation for management services and capital returns.

My written testimony discusses some of the analytical issues involved in those different perspectives. It also examines a few recent proposals to change the taxation of carried interest and the pros and cons thereof. I will defer to your question period if you would like to ask more about those.

In closing, I just want to emphasize that much of the complexity that is associated with taxation of carried interest arises because of the differential tax rate on capital income and ordinary income. In particular, because ordinary income for high income tax payers is typically subject to a 35 percent marginal income tax rate, whereas, long-term capital gains are subject to a 15 percent tax rate, there is a strong incentive to shift income into forms classified as capital gains.

Whether carried interest represented compensation for services provided or a return on capital invested would be largely irrelevant if the tax rate on labor and capital income were the same.

Thank you very much.

[The prepared statement of Mr. Orszag follows:]

CBO TESTIMONY

Statement of
Peter R. Orszag
Director

The Taxation of Carried Interest

before the
Committee on Ways and Means
U.S. House of Representatives

September 6, 2007

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CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Chairman Rangel, Congressman McCrery, and Members of the Committee, thank you for inviting me to testify on the taxation of carried interest.

My testimony makes the following main points:

- A growing amount of financial intermediation is occurring through private equity and hedge funds. Typically organized as partnerships or limited liability companies, those funds now have at least $2 trillion under management. Many private equity funds attempt to identify underperforming and inefficient publicly traded firms, buy a controlling share of those companies, restructure their operations and management, and then resell them at a higher price. Others seek out attractive investment opportunities in undervalued small start-up companies. By contrast, hedge funds traditionally have attempted to identify opportunities for arbitrage, in which combinations of financial instruments with the same expected cash flows have different market prices.

- A general partner of a private equity or hedge fund typically receives two types of compensation: a management fee tied to some percentage of assets under management and "carried interest" tied to some percentage of the profits generated by those assets. The management fee is taxed as ordinary income to the general partner. Taxation of the carried interest is deferred until profits are realized on the fund's underlying assets, and any resulting profits to the general partner are taxed at the capital gains tax rate to the extent that the fund's profits reflect capital gains.

- However, most economists would view at least part, and perhaps all, of the carried interest as performance-based compensation for management services provided by the general partner rather than as a return on financial capital invested by that partner. That perspective would suggest taxing at least some component of the carried interest as ordinary income, as most other performance-based compensation is currently treated, regardless of the nature of the underlying investments generating the profits of the fund.

- A variety of proposals have been put forward to alter the tax treatment of carried interest. Policymakers considering those changes need to evaluate many factors, including the potential distortions created by the current tax treatment of partnerships and carried interest relative to that of other organizational forms and types of income; the consequences for a broad range of industries (including real estate development) if a general solution is adopted—or the advisability of industry-specific rules if a solution targeted to financial investment funds is pursued; the potential unintended effects, complexity, and perceived fairness of tax changes; and any impact on net tax revenues.

- Much of the complexity associated with the taxation of carried interest arises because of the differential between the capital gains tax rate and the ordinary income tax rate, which creates an incentive to shift income into a form classified as capital gains. Further widening of that differential between the taxation of capital gains and of ordinary income would create even stronger incentives to shift income into the tax-preferred form of capital.

I would also emphasize that any revenue estimates associated with changing the tax treatment of carried interest would be undertaken by the Joint Committee on Taxation. My testimony therefore does not discuss specific revenue effects from proposed changes to that tax treatment.

Recent Innovations in Financial Services

Financial markets have experienced substantial innovation over the past several decades. Those innovations have affected the assessment and pricing of risk (including the development of credit derivatives and interest rate swaps) and the use of financial markets in supplying credit. The resultant changes in the allocation of capital and the pricing and dispersion of risk have probably contributed to continued economic growth. By increasing businesses' and households' access to capital, financial innovations probably also help explain the dampening of business cycles and the significant decrease in macroeconomic volatility over the past two decades.[1] The innovations also, however, have facilitated individual market participants' ability to assume substantially greater degrees of risk and thus have raised concerns about potential systemic risks to the financial system. Recent problems in the subprime mortgage market have underscored those types of concerns.

Private equity and hedge funds in particular have played an increasingly important role as financial intermediaries:

- **Private equity** funds raise capital to purchase or invest in new and existing businesses. They are private in the sense that their ownership interests are not publicly traded. Instead, they raise investment capital outside public financial markets from sources such as pension funds, endowments and foundations, and wealthy individuals. With those funds, they make various investments, including in publicly traded companies. Private equity firms may acquire mature public companies with the intent of converting them to private companies, restructuring or reorganizing their activities, and then reselling them to the public or another firm. The initial purchase of a public firm by a private equity fund

1. See Karen E. Dynan, Douglas W. Elmendorf, and Daniel E. Sichel, *Can Financial Innovation Help to Explain the Reduced Volatility of Economic Activity?* Finance and Economics Discussion Series, Working Paper No. 2005-54 (Washington, D.C.: Federal Reserve Board, November 2005). The decline in macroeconomic volatility, however, does not appear to have been associated with a reduction in the volatility of household earnings or income. See the statement of Peter R. Orszag, Director, Congressional Budget Office, *Economic Volatility*, before the Joint Economic Committee (February 28, 2007).

can be done through a leveraged buyout (LBO), in which the private equity firm relies heavily on debt raised from third-party investors to finance the necessary purchases of the public company's shares. Venture capital is a type of private equity particularly used in investing in small start-up businesses.

- **Hedge funds** trade in a variety of financial markets and typically adopt complicated investment strategies, often involving financial derivatives. Some funds buy and sell stocks of publicly traded companies or derivative instruments based on stocks, such as options. Some specialize in debt instruments based on corporate loans, mortgages, and credit card debt. Many derivatives of subprime mortgages are held in hedge funds. Other hedge funds specialize in trading currencies, commodities, and derivatives based on them. Despite their name, hedge funds are not necessarily "hedged" in the traditional sense of being insulated from risk; many hedge funds take significant risks either knowingly or unknowingly. As with private equity funds, hedge funds do not raise their own capital through public issuance of securities; instead, they typically raise capital from institutions and wealthy individuals. Hedge funds' investments are often intended to be shorter term and typically do not involve management control, in contrast to the investments made by private equity funds, although the distinction between hedge funds and private equity funds can become blurred in practice.

The effects of those types of intermediaries on financial markets and overall economic efficiency are complicated to assess. In purchasing target firms, private equity funds have historically paid a premium of about 20 percent over the current market value, which is somewhat less than the amount offered by publicly traded takeover companies.[2] The acquired companies are held for an average of about seven years before the funds bring them back to market for resale. Private equity funds usually retain a significant ownership and management interest in the retooled firms. Such firms that have been resold to the public appear to outperform the market after the sale.[3] Firms resold to the public, however, are a small fraction of all acquired companies, and the returns to those firms may not be representative. Further, it is not clear why resold firms should continue to outperform if equity markets are operating efficiently.

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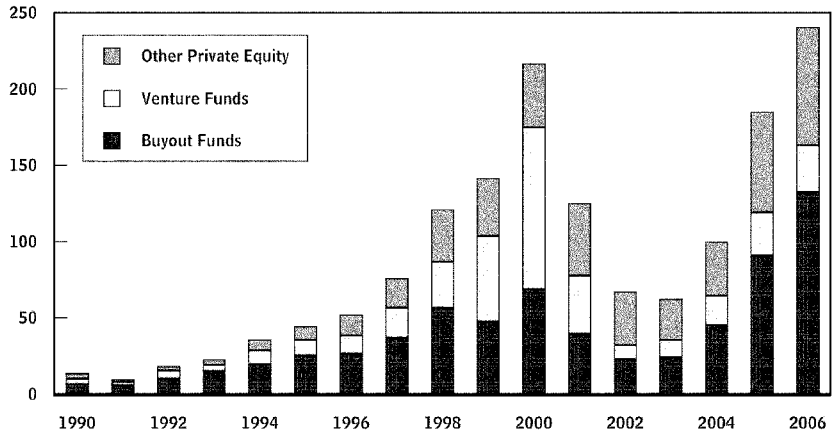
2. Leonce Bargeron and others, *Why Do Private Acquirers Pay So Little Compared to Public Acquirers?* Working Paper No. 13061 (Cambridge, Mass.: National Bureau of Economic Research, April 2007).

3. Jerry X. Cao and Josh Lerner, *The Performance of Reverse Leveraged Buyouts*, Working Paper No. 12626 (Cambridge, Mass.: National Bureau of Economic Research, October 2006).

Figure 1.

Capital Raised by U.S. Private Equity Funds

(Billions of dollars)



Source: Congressional Budget Office based on data from Thomson Financial, Morgan Stanley Research.

The role of private equity and hedge funds has expanded substantially in the past 20 years. From 1980 to 1995, the amount of capital under management in the private equity market increased from roughly $5 billion to over $175 billion.[4] In the past decade, the market has continued to experience rapid growth, and by some estimates, private equity funds now have more than $1 trillion under management. Estimates also suggest that roughly 8,000 to 9,000 hedge funds now exist, with more than $1 trillion in funds under management. In other words, private equity funds and hedge funds together have more than $2 trillion under management.

In 2006, private equity firms raised more than $240 billion in capital, up from less than $25 billion a year in the early 1990s (see Figure 1). The private equity market is dominated by a small number of major players. Over the past five years, the top five private equity firms have raised an average of $30 billion in capital. The average amount raised among the next five largest firms was $18 billion, and among the next 40 largest firms, about $8 billion.

The volume of private equity deals more than doubled in 2006, with LBOs accounting for almost 20 percent of the $3.5 trillion in global mergers and acquisi-

4. See Stephen D. Prowse, "The Economics of the Private Equity Market," *Economic Review*, Federal Reserve Bank of Dallas (Third Quarter 1998), pp. 21–34.

tions. This year, LBOs accounted for more than 17 percent of the $2.26 trillion in deals through June 2007 and are on pace to break last year's record volume.[5]

Tax data provide another indication of the significant income that flows through entities such as private equity and hedge funds, along with other partnerships and S corporations. In 2005, capital gains from partnerships and S corporations were 22 percent of the total current-year long-term capital gains reported on individual income tax returns and 27 percent of the gains received by the 1 percent of taxpayers with the highest income (those figures do not include losses carried over from previous years).

Structure and Tax Treatment of Private Equity and Hedge Funds

Most private equity and hedge funds are organized as partnerships or limited liability companies. In most of this testimony, they are referred to simply as partnerships, because the tax characteristics of partnerships and most limited liability companies are essentially identical.

A partnership typically consists of one or more general partners, who manage the entity and determine the investment strategy, and limited partners, who contribute capital to the partnership but do not participate in management. General partners may also invest their own financial capital in the partnership, but such investments usually represent a small share of the total funds invested. (The general partner is itself typically a partnership, with the individual managers of the fund as partners.)

Several factors may motivate private equity and hedge funds to be organized as partnerships. A partnership structure is often attractive because its flexibility can accommodate complex financial arrangements among those managing the fund and those contributing capital to it. However, it is likely that tax law plays an important role in explaining why so much financial management activity is now occurring through partnerships. In particular, private partnerships (and limited liability companies electing to be treated as a partnership for tax purposes) do not pay a separate corporate income tax. Instead, they pass all income and losses through to the partners, who are liable for any income tax. As described below, the partnership structure is also attractive to investment fund managers because of the manner in which part of their compensation (the so-called carried interest) is taxed.

In contrast to private partnerships, publicly traded partnerships are generally treated as corporations for tax purposes and are subject to the corporate income tax. (The primary exception to that rule is that certain partnerships that derive at least 90 percent of their income from passive investments such as dividends, interest, rents, and capital gains or from mining and natural resources and that are

5. Thomson Financial, as cited in "Who's Who in Private Equity," *The Wall Street Journal Online*, available at www.wsj.com.

therefore not required to register as investment companies under the Investment Company Act of 1940 do not pay the corporate tax.)

The taxation of the partnership entity itself is not the primary focus of my testimony, although it is worth noting that corporate income tax revenues have declined over the past several decades relative to the size of the economy, partly because of the effects of financial innovation and global integration and possibly because of the increased use of noncorporate forms of conducting business (which were created in part to avoid the potential distortions associated with corporate taxation).[6] Developments such as the growth of private equity and hedge funds may affect corporate income tax revenues in the future; a number of private equity firms, for example, are taking steps to go public without relinquishing their exemption from the corporate tax. Legislation introduced by Senators Baucus and Grassley would tax as corporations publicly traded partnerships that derive income from managing assets or advising investors.

Carried Interest

A general partner in a private equity or hedge fund is typically compensated in two ways: through a fixed management fee and a share of profits.

The fixed management fee, usually 1 percent to 2 percent of the assets under management, does not depend on the performance of the fund. For example, if the fund had $1 billion in assets under management and a 2 percent management fee, the management fee would amount to $20 million a year, regardless of the return on the $1 billion in assets. The $20 million would be taxed as ordinary income to the general partner and would generate a deduction as an investment expense for the limited partners.

The second component of the general partner's compensation is a share of the profits on the assets under management. That component, which is often 20 percent of such profits, is usually referred to as carried interest (or, simply, carry).[7] For example, assume the fund with $1 billion in assets generated a 15 percent realized profit in a year. Of the $150 million in profits, the general partner earning 20 percent carried interest would receive $30 million. The other $120 million in

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6. Corporate tax revenues declined from 3.6 percent of gross domestic product (GDP) in 1962 to 1.2 percent in 2003. A recent surge in corporate tax collections has temporarily reversed that longer-term trend—corporate tax revenues rose from 1.2 percent of GDP in 2003 to 2.7 percent in 2006, explaining the bulk of the overall increase in federal revenues over that time—but CBO projects a gradual decline in that share from current levels. See Congressional Budget Office, *Federal Tax Revenues from 2003 to 2006* (May 18, 2007), and *The Budget and Economic Outlook: Fiscal Years 2008 to 2017* (January 2007).

7. Managers of public mutual funds are not permitted to be paid in that fashion. Because private equity and hedge funds are exempt from the Investment Company Act of 1940, however, that form of compensation is permitted for their managers.

profits would be split among the investors in the fund (including the general partner if he or she owned some of the capital in the fund in addition to managing it). In many cases, the general partner earns carried interest only when profits exceed some threshold.[8] For example, in many private equity funds, the general partner will receive carried interest only when profits exceed a "hurdle rate," often an 8 percent return.[9]

Tax Issues Surrounding Carried Interest

Carried interest arrangements for partnerships raise two significant tax issues: the timing and the character of the income earned by the general partner. Both of those issues involve the same underlying question, which is whether, which is whether a general partner's carried interest should be treated as a quasi-investment in the partnership by the general partner, with the result that the carried interest would be subject to the same tax rules that apply to the limited partners' partnership interests, or whether the general partner's carried interest is more properly viewed as some form of contractual undertaking by the limited partners (or the partnership) to compensate the general partner for management services.

Deferral of Taxation

The first tax issue involves the timing of a general partner's tax liability for the carried interest that he or she receives for managing the fund. Under current law and regulations, carried interest is not taxed when the right to the future profits is granted (for example, when the partnership is created) but rather when the partnership realizes profits that are allocated to the general partner.

At one level, deferral is a specific example of a more pervasive phenomenon, which is the tax code's reliance on realization events—the sale of an investment, for example—to determine the timing of income from investments. Indeed, limited partners in a private equity fund also enjoy the benefits of deferral: They do not pay tax on unrealized gains but only on gains that have been recognized through a sale or similar event.

At another level, however, deferral as applied to a general partner's carried interest effectively assumes the conclusion of the underlying technical and policy issue: whether that carried interest should be treated as a simple investment by the general partner (albeit one that has no claim to the current capital of the fund but only to the future appreciation thereof) or whether, at least to some degree, the carried

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8. Such a preferred return for the limited partners is more common in private equity buyout firms than in venture capital firms. See Victor Fleischer, *The Missing Preferred Return*, Research Paper No. 05-8 (Los Angeles: UCLA School of Law, February 2005).

9. If that 8 percent hurdle rate applied to the example, the general partner would receive the 20 percent carried interest on $70 million (which is the $150 million in profits minus the threshold of $80 million that must be exceeded before carried interest applied), or $14 million.

interest is in substance a form of compensation paid by the limited partners to the general partner for services in managing the fund. Most analysts believe that alternative characterization is more accurate.

More specifically, carried interest can be viewed as a call option on a limited partnership interest, with a value equal to 20 percent of the future capital in the fund and a strike price equal to 20 percent of the initial value of the fund.[10] Options-pricing formulas, such as the Black-Scholes formula, can then be applied to valuing the carried interest. Although various complications arise in applying such options-pricing techniques (including the requirement to estimate both the duration of the fund and the volatility of the underlying investments), it is clear that whatever the imperfections in the valuation process, an interest in future profits has some value greater than zero.

It is worth noting that deferral of taxation on carried interest generates a tax benefit to the general partner (who does not recognize income initially) but a tax cost to the limited partners (who do not enjoy a deduction or other reduction in taxable income at that point). However, many limited partners are either tax-exempt entities in the United States or foreign institutions (see Table 1), so they may be largely unaffected by the lack of an immediate U.S. tax benefit. The net result is, therefore, the overall deferral of a net tax liability.

Treatment as Capital Gains or Ordinary Income

The second issue is the character of the income received as carried interest. Under current law and regulations, carried interest is treated in the same way as all other profits from a partnership for tax purposes. In particular, carried interest flows through to the general partner on the basis of the nature of the income from the underlying investments. Thus, if the carried interest arises from realizations of long-term capital gains on the investments held by the fund, the general partner is taxed on the carried interest at the long-term capital gains rate. In the paradigmatic private equity case, most profits arise from long-term capital gains, so the profit allocated to the general partner's carried interest will be taxed as long-term capital gains.[11] For simplicity, the remainder of this testimony assumes that case and also assumes that no hurdle rate is applied to the carried interest. Such a hurdle rate

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10. A call option gives the holder the right to purchase an asset at the strike price. Consider a fund with $1 billion under management and 20 percent carried interest. If the fund then grows to $1.5 billion, the general partner will be entitled to 20 percent of the $500 million increase, or $100 million. That outcome is equivalent to a right to receive 20 percent of the future value of the fund ($1.5 billion x 20 percent = $300 million) in exchange for paying 20 percent of the initial value of the fund ($1 billion x 20 percent = $200 million). The example assumes that no hurdle rate is applied to the carried interest; the presence of such a hurdle rate would be reflected in the valuation of the option.

11. A hedge fund's income from securities trading, by comparison, usually constitutes a short-term capital gain or ordinary income—particularly if, as often is the case, the fund has elected to be taxed as a securities trader under section 475(f) of the Internal Revenue Code.

Table 1.

Percentage of Capital Investment in Private Equity by Type of Limited Partner

	2005[a]	2006[b]
Public Pension Funds	22	26.6
Corporate Pension Funds	10	12.3
Union Pension Funds	1	1.4
Banks and Financial Services	6	9.8
Insurance Companies	12	7.5
Endowments/Foundations	10	7.7
Family Offices	11	6.8
Wealthy Individuals	10	10.1
Funds of Funds	13	13.9
Other	5	3.9
Total	**100**	**100**

Source: Private Equity Council, *Public Value: A Primer on Private Equity* (Washington, D.C., 2007), p. 11.

a. Based on a sample of more than 75 global funds with total capital of over $32 billion.

b. Based on a sample of more than 110 global funds with total capital of over $44 billion.

would affect the precise examples and calculations but not the underlying substance of the issue.

To see how that system of taxation works, assume that a fund realized a profit of $150 million in long-term capital gains and that the carried interest was equal to 20 percent of that profit, or $30 million. The general partner would then pay capital gains tax on that $30 million; at a capital gains tax rate of 15 percent, the tax owed would be $4.5 million.

As an economic matter, the character of carried interest income should not depend on whether the compensation is performance-based. A wide range of performance-based compensation—including arrangements in which service providers accept the entire risk of the success or failure of an enterprise—is effectively labor income and taxed as ordinary income for services. Contingent fees based on movie revenue for actors, for example, are taxed as ordinary income, as are performance bonuses, most stock options, and restricted stock grants.[12] So too are incentive fees paid to managers of other people's investment assets, when those fees are doc-

12. The tax treatment of nonqualified stock options, which are the most common type of options, is an example. Nonqualified stock options are generally taxed when they are exercised (although the tax can be delayed if the purchased shares are subject to a substantial risk of forfeiture), and the difference between the market price at the time of exercise and the strike price (multiplied by the number of shares) is taxed as ordinary income. The tax treatment of incentive stock options is more advantageous, but current law significantly limits the value of such options that can receive favorable tax treatment.

umented as such rather than as carried interest in a formal partnership. Instead, the key issue is whether the carried interest represents a fee for services provided or a return on the partnership's long-term capital gains allocated to one partner (the general partner) under conditions that are not qualitatively different from the returns allocated to the other partners (the limited partners).

Most legal and economic analysis suggests that carried interest represents, at least in part, a form of performance-based compensation for services undertaken by the general partner. Although individual analyses differ slightly, there are two important themes with which most analysts concur. First, a general partner in a private equity or hedge fund undertakes a fundamentally different economic role from that of the limited partners, because the general partner is responsible (by virtue of his or her expertise, contacts and experience, and talent) for managing the fund's assets on a day-to-day basis. Second, the carried interest is not principally based on a return on the general partner's own financial assets at risk. If the purpose of the preferential rate on long-term capital gains is to encourage investors to put financial capital at risk, there is little reason for that preference to be made available to a general partner, whose risk involves his or her time and effort rather than financial capital.

Some observers view carried interest as a mixture of compensation for management services and capital returns. For example, one can think of carried interest as an interest-free nonrecourse loan from the limited partners to the general partner equal to 20 percent of the partnership's assets, with the requirement that the loan proceeds be reinvested in the fund. (A borrower is not personally liable for a nonrecourse loan, beyond the pledged collateral, which in this case is the general partner's claim on future profits.) To see how this example works, imagine a fund worth $100 million. With no direct capital investment, the carried interest entitles the general partner to the profits on $20 million (20 percent of the profits on $100 million is equivalent to the full profits on $20 million). It is therefore as if the limited partners have contributed $80 million to the fund and then lent the general partner $20 million to invest in the fund too, but without charging the general partner interest on that loan.

This perspective of characterizing carried interest as an implicit loan would result in treatment somewhere between those of purely capital income and purely ordinary income. In particular, under current tax rules, the implicit interest on an interest-free loan would be taxed as ordinary income, with the interest rate set at the current rate on federal securities with the same duration as the loan. At the time the partnership sold its assets, any gain or loss to the general partner, after paying back the loan, would be treated as capital. In effect, then, this perspective would suggest that the component of carried interest attributable to implicit interest on the

implied loan would be ordinary income and that the returns in excess of that implicit interest would be capital income.[13]

The differential tax treatment of carried interest relative to the management fees earned by general partners has apparently led to efforts to transform management fees into carried interest. Consider the example of the $1 billion investment fund with a 2 percent management fee, 20 percent carried interest, and a 15 percent realized profit on long-term capital gains. The general partner would then receive $50 million in income: $20 million in management fees and $30 million in carried interest. With a 35 percent ordinary income tax rate and a 15 percent long-term capital gains tax rate, the general partner would pay $11.5 million in income taxes. If the general partner was able to reduce the management fee to 1 percent and increase the carried interest to 26.7 percent, the income flowing to the general partner would remain $50 million ($10 million in management fees and $40 million in carried interest). However, the taxes owed would decline by $2 million, to $9.5 million. Such transformations of management fees into carried interest have apparently occurred, in some cases even after realized profits are known. Those types of transformations further highlight some of the similarities between—and, therefore, the interchangeability of—management fees and carried interest. That those components of compensation are substituted for each other suggests, at least in part, that both types of income represent compensation to the general partner for management of the fund.

Finally, the issue of characterizing a flow of income as a return on capital or compensation for services provided is not unique to private equity or hedge fund partners and is not a new development. Many real estate development deals, for example, are structured as partnerships with essentially similar characteristics, in which

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13. A hurdle rate or preferred return would affect the calculation of the forgone interest. If the preferred return was set at the same rate as the interest rate on the implicit loan, it would not be appropriate to impute an additional interest charge on the implicit loan, although there would need to be some provision to account for the implicit below-market rate if the private equity fund failed to achieve a return at least equal to the preferred rate. For example, consider a private equity fund that starts with $100 million in assets and grows at a 15 percent rate each year. If profits are realized after seven years, the general partner earning 20 percent carried interest will receive $33.2 million of the $166 million in total profits. With a preferred rate of 6 percent, the limited partners will receive the first $50.4 million in profits, and the general partner will receive $23.1 million—20 percent of the remaining $115.6 million in profits above the preferred return. Compare that instead with treating the 20 percent carried interest as a nonrecourse loan with an interest rate equal to the 6 percent preferred rate. In that case, the general partner would be treated as if he or she had received a $20 million loan from the limited partners that he or she then invested in the fund, obtaining 20 percent capital interest. After seven years, the general partner would receive $53.2 million—20 percent of the fund's $266 million in assets. After paying back the $20 million loan with interest compounded at 6 percent per year ($30.1 million), the general partner would be left with $23.1 million, as above.

an active manager or developer obtains a disproportionate share of partnership income or profits in return for his or her contributions of intangibles (contacts, know-how, and so forth) and management of the project. Nonetheless, the typical private equity firm presents the paradigmatic case for considering the appropriate tax treatment of carried interest (see Box 1 for a related discussion— of "sweat equity" and carried interest).

Options for Modifying the Tax Treatment of Carried Interest

The tax issues described in the previous section have given rise to proposals to change the current tax treatment of carried interest. Policymakers considering such proposals may want to weigh the underlying substance of the tax issue at hand with various other considerations. For example, in general, changes in tax policy that have significant and potentially unexpected effects on particular industries should be approached with caution, because a broader policy objective may be served by stability and an associated perception of fairness. Furthermore, as noted above, carried interest arises not just within private equity and hedge funds; it is also a common feature of partnerships in other sectors. Many of the underlying tax issues that relate to the taxation of carried interest in the financial services sector apply to those other sectors as well. Policymakers interested in changing the tax treatment of carried interest therefore need to evaluate the costs and benefits of changing that treatment for all carried interest relative to restricting the change to the financial services industry.

One concern that has been raised about altering the tax treatment of carried interest is that it may drive private equity and hedge fund activities abroad. However, a significant number of such funds are already registered offshore. Despite foreign registration, most private equity and hedge fund activities still take place in financial centers such as New York; Greenwich, Connecticut; and London. Changes in the tax treatment of carried interest would be unlikely to drive those activities away to any significant degree: The changes would not generally affect the taxation of the limited partner investors in such funds, and with regard to the general partner, the United States taxes the worldwide income of its citizens, wherever they may perform services. U.S. citizens who are managing partners in private equity funds or hedge funds will therefore generally be taxed by the United States wherever they may choose to live and operate their businesses.

Several proposals have been put forward to modify the tax treatment of carried interest. Under those proposals, some, if not all, carried interest would be treated

as ordinary income regardless of the type of asset generating the fund's profits.[14]

Tax Carried Interest as Property When Granted. One alternative would be to tax the general partner on carried interest when granted. Under section 83 of the Internal Revenue Code, property (other than an option) transferred to a person in connection with the performance of services is generally taxed when that property is transferred. Under relatively unusual facts, the tax court held in *Diamond v. Commissioner* that the grant of a carried-interest right "with determinable market value" constituted current ordinary income to the general partner.[15] Because carried interest may be difficult to value, though, most practitioners continued to view the granting of carried interest as a nontaxable event. The Internal Revenue Service later embodied that view in Revenue Procedure 93-27. One possibility would be to alter that revenue procedure and apply section 83 to the grant of carried interest. The valuation could then be done by Black-Scholes or some other method.[16] The grant would be currently taxable as ordinary income to the general partner and could generate a deduction for the limited partners.[17]

This approach would affect both the deferral component of carried interest and its character. For the reasons described above regarding the limited impact from a deduction granted to the limited partners, the result would be a net acceleration of revenues received by the federal government. Another result would be that the carried interest (its value determined at the time it was granted) would be treated as ordinary income. To the extent that the carried interest then appreciated or depreciated in value relative to the initial estimate, the changes would be taxed as capital gains or losses.

This approach would require some acceptable valuation methodology, which might be difficult to apply in the wide variety of circumstances in which carried interest arises. Furthermore, even with an accepted valuation methodology, modest changes in the assumptions applied might generate significant changes in valuation—creating opportunities to understate the value of the carried interest when granted. Finally, as noted above, deferral arises in a variety of settings across the

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14. To implement any of the options, policymakers would also need to decide whether to treat the resultant ordinary income as labor income; if so, the income would also generally be subject to payroll taxation. The arguments in favor of viewing carried interest as ordinary income would tend to suggest that tax treatment.

15. *Diamond v. Commissioner*, 56 T.C. 530 (1971) (*aff'd*), 492 F. 2d 286 (7th Cir. 1974).

16. See, for example, Lee A. Sheppard, "Blackstone Proves Carried Interests Can Be Valued," *Tax Notes*, vol. 115, no. 13 (June 25, 2007), pp. 1236–1243.

17. Although the valuation of the grant may be undertaken using options-pricing methodologies, this tax treatment would differ from that applied to nonqualified stock options, which are typically taxed not when they are granted but when they are exercised.

Box 1.

Sweat Equity and Carried Interest

To some observers, carried interest simply reflects the "sweat equity" of the partner providing the know-how—that is, his or her investment of time and energy rather than financial capital. Those observers typically argue that carried interest should not be treated as ordinary income because other sweat equity is taxed as capital income.

Consider two individuals who open a shop. One of them provides all of the cash, the other provides the know-how, and each takes a 50–50 interest in the partnership. The issue is how the partner providing the know-how is taxed—and how that tax treatment corresponds to that for carried interest.

In analyzing those questions, it is important to distinguish two different levels of taxation: the taxation of annual operations over the firm's life and the taxation of gains realized by the partners if they sell the firm. When observers argue that people who are providing labor to a partnership should be taxed on the compensation for that labor at rates for ordinary income, they are referring to the taxation of the current year's operations, not to the gains realized on the ultimate sale of the firm. In particular, assume that the 50–50 split is of partnership profits only and that the partner providing the know-how does not obtain any current interest in the capital contributed. (If that partner was given a capital interest in the partnership, which entitled him or her to a share of the proceeds if the partnership was immediately liquidated, that share would be treated as immediate taxable income to the partner.)

Then consider what happens as the operation sells its products to customers. The business will earn ordinary business income from its operations; that ordinary business income will be shared by, and taxed to, the two partners according to their partnership agreement. As a result, the partner providing the know-how will pay tax every year at ordinary income rates on his or her 50 percent share of the partnership's profits.

Box 1.

Continued

After some time, the two partners sell the partnership for a price that reflects not only machinery, leasehold improvements, and products in inventory but also the operation's good will, trade name, and similar intangibles. Tax law provides that the profit from the sale of the business for the partner providing the know-how (to the extent that the profit is not attributable to certain ordinary income assets of the partnership) will constitute long-term capital gains. In effect, then, tax law distinguishes between the current returns from the sweat equity provided by that partner—annual operating profits, which are taxed as ordinary income—and that partner's share of the value that his or her work has helped to create when the partner sells those self-created intangible assets through the sale of his or her interest in the partnership—which will be treated as long-term capital gains.

A similar outcome on the final sale of an operation has occurred with some recent initial public offerings of private equity management companies that were organized as partnerships. The owners of a management company sold their interests for prices significantly above their tax basis in their partnership interests.

At least in part, their sales price represented the good will, trade name, and value of the management business as a going concern, which the partners had built up through years of hard work. Those partners appear to have treated the gain attributable to those sorts of intangible assets as long-term capital gains; analysts who believe that carried interest represents performance-based compensation for

services provided would nonetheless probably agree that such treatment of proceeds from the sale of the management company itself as long-term capital gains is indeed appropriate. Thus, the issue of the treatment of carried interest relates to the taxation of the private equity management company's operating profits, not to the taxation of the sale of the company.

tax code, and some observers believe that eliminating deferral in this context but not others would not be justified.[18]

Tax Carried Interest as Ordinary Income When Realized. A second option would be to continue to allow deferral but to view carried interest as a fee for services provided and therefore tax the income distributed to the general partner as ordinary income. Carried interest would thus be taxable to the general partner as ordinary income and deductible as an expense incurred to earn investment income to the limited partners.[19] As an example of this broad approach, consider the fund with $1 billion in assets and 20 percent carried interest. If the fund earned a realized profit of 50 percent, the carried interest of $100 million would be taxed to the general partner as ordinary income (rather than capital gains). At a 35 percent tax rate, the income tax owed would be $35 million, rather than the $15 million that would be due if the income was taxed at the 15 percent capital gains tax rate.[20]

H.R. 2834, introduced by Congressman Levin and others, would implement a version of this approach. Another approach that is similar in spirit involves modifying section 707(a)(2)(A) of the Internal Revenue Code to require that carried interest be treated as a transaction between the partnership and a nonpartner; the result would be to treat the carried interest as ordinary income.[21]

This type of approach would most closely mirror the tax treatment of nonqualified corporate stock options, which share many characteristics with carried interest. As with the tax treatment of nonqualified options, this approach would not eliminate the deferral of taxation (because it would not impose the tax when the carried interest was granted), but it would impose ordinary income taxation.[22] This

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18. For example, carried interest in the partnership context has much in common with employee stock options that a corporation might grant to valued employees. The tax code typically taxes those options as ordinary income only on exercise, in an amount equal to an employee's economic gain at that time (that is, the difference between the corporate stock's fair market value on the exercise date and the price paid by the employee under the terms of the option). Policymakers may want to consider whether it is appropriate to create a timing rule for carried interest that would vary significantly from the general rule adopted for somewhat analogous nonqualified employee stock options.

19. Various provisions of the tax code could reduce the value of the deduction to the limited partners.

20. Again, the limited partners would receive an ordinary income tax deduction, but the net effect would probably be a revenue gain for the reasons described earlier in the text.

21. See Lee A. Sheppard, "The Unbearable Lightness of the Carried Interest Bill," *Tax Notes*, vol. 116, no. 2 (July 12, 2007), pp. 15–21.

22. As described, nonqualified stock options are generally taxed not when they are granted, but rather when they are exercised—apparently because of concerns about valuation. Such concerns are similar to those surrounding the value of carried interest when granted, and the typical deferral of taxation on nonqualified stock options until they are exercised may suggest that the taxation of carried interest should also be deferred, as this option would entail.

approach would also most directly reflect the view that carried interest fully represents performance-based compensation for services provided.

The approach might, however, create various tax-planning opportunities—including the use of nonrecourse loans from the limited partners to the general partner—to attenuate its impact. Finally, although there is widespread agreement among analysts that at least some component of carried interest represents compensation for services provided, there is somewhat less agreement that the full amount of carried interest represents such compensation. To the extent that at least some component of carried interest is viewed as a return on capital invested, this approach could be seen as overtaxing carried interest.

Tax Imputed Interest on the Implied Loan. A third option would be to explicitly treat the general partner's carried interest as a nonrecourse loan from the limited partners and tax the value of the implicit interest to the general partner as it accrued.[23] As a result, that part of the carried interest would be treated as ordinary income, and the rest would be treated as a return on capital.

Consider again a private equity or hedge fund partnership that starts with $1 billion in assets. The underlying assets are sold after three years for $1.5 billion, generating a realized profit of $500 million. With 20 percent carried interest, the general partner would receive $100 million when the fund liquidated or sold the assets (20 percent of the $500 million profit). Under current law, the general partner would pay a tax of $15 million on his or her share of the profits (15 percent of $100 million), under an assumption that the distributions qualified as long-term capital gains. If the carried interest was treated as ordinary income, as in the option above, the general partner would pay a tax of $35 million (35 percent of $100 million).

If, instead, the 20 percent carried interest was treated as a nonrecourse interest-free loan with the loan proceeds invested in the fund, the general partner would generally pay more tax than under current law but less than under the option treating carried interest as ordinary income. In particular, in the example, the general partner would be treated as if he or she had received a $200 million loan from the limited partners, which he or she then invested in the fund, obtaining a 20 percent interest in the fund. After three years, the general partner would be treated as if he or she received a 20 percent share of the $1.5 billion in assets held by the fund, or $300 million, and paid back the $200 million loan. The general partner would thus have a realized gain of $100 million (the underlying carried interest). The tax on that $100 million would be $15 million, again under the assumption that the fund's profits qualified as long-term capital gains. However, because the loan from the limited partners was interest-free, the general partner would be required by current

23. One analyst describes this option as a cost-of-capital approach. See Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, Legal Studies Research Paper No. 06-27 (Boulder, Col.: University of Colorado Law School, June 12, 2007).

law to count the forgone interest payments as ordinary income and pay tax on them each year.[24] With a 5 percent interest rate, the implied ordinary income would be $10 million per year, and the tax would be $3.5 million per year.[25] The time value of money aside, the total tax bill would be $25.5 million ($15 million plus $10.5 million). That tax liability, as expected, falls between the tax liability of $15 million under full capital gains tax treatment and the $35 million under full ordinary income tax treatment.

One advantage of this approach is that it may be more resistant to financial planning that does not change the underlying economics of the partnership arrangement. It also reflects the view of some analysts that carried interest is neither entirely a return on capital nor entirely labor compensation. However, the approach is clearly complex, and the extent of the complications involved may make it particularly difficult to implement in practice.

A Broader Issue: Differential Tax Rates on Capital and Labor Income

Much of the complexity associated with the taxation of carried interest arises because of the differential between the capital gains tax rate and the ordinary income tax rate. In particular, ordinary income for high-income taxpayers is typically subject to a 35 percent marginal income tax rate and, in the case of labor income, an additional 2.9 percent payroll tax rate for Medicare. Long-term capital gains for such taxpayers are typically subject to a 15 percent tax rate. The difference creates a strong incentive to shift income into forms classified as capital gains. Whether carried interest represented compensation for services provided or a return on capital invested would be largely irrelevant if the tax rates on labor and capital income were the same (although the issue of deferral would still remain).

The Tax Reform Act of 1986 set the tax rate on capital gains at the same rate as the tax on ordinary income, but legislation since then has reintroduced differential tax treatment. A lower tax rate on capital gains and dividends than on other forms of income creates opportunities for tax avoidance and complicates the tax system. Income from sole proprietorships, S corporations, and other noncorporate entities

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24. This option assumes that the general partner would not receive a deduction for the imputed interest payments on the implicit loan. Under current law, imputed interest on actual loans may generate a deduction for the borrower. Advocates of this option, however, would not extend such a deduction to the general partner (the borrower of the implicit loan); they justify such a deduction in different ways. In addition, the example assumes no hurdle rate or preferred return. As noted, such a provision would affect the calculation.

25. The example follows the convention of using the federal interest rate on short-term securities. The choice of the proper interest rate is a significant issue in this approach, though. A 5 percent interest rate is arguably too low for a nonrecourse loan on a risky asset. Again, the presence of a hurdle rate would affect the calculation of implicit interest.

is a mix of returns on capital and returns on labor, and a significant portion of the tax code is devoted to attempting to distinguish one type of income from another.

As the tax rate differential increases, the distinctions among different types of income assume greater importance. Proposals to reduce the tax on capital income (for example, by moving to a consumption tax) or to raise the tax on labor income (for example, by increasing the payroll tax) would increase the differential further and thereby create an even stronger incentive to shift income into a form classified as capital.

One motivation for differential tax treatment has been a desire to promote capital formation and economic activity. The empirical evidence suggests, however, that a low capital gains tax rate has only modest effects on such outcomes. Furthermore, the application of that broader motivation to carried interest in investment funds is unclear, because the financial capital that is gathered and invested in such funds is provided almost entirely by the limited partners, not the general partner.

Many considerations need to be taken into account in evaluating the appropriate tax rate on capital income. The income-shifting incentives and potential associated distortions created by differential rates on capital and income, which are highlighted by the debate over carried interest, represent one consideration.

Mr. LEVIN OF MICHIGAN. Thank you.
Mr. Levin.

STATEMENT OF JACK S. LEVIN,
PARTNER, KIRKLAND & ELLIS LLP

Mr. LEVIN. Mr. Chairman and Committee Members: My name is Jack Levin. I teach at Harvard Law School and University of Chicago Law School, and I'm author or co-author of 5,800 pages of exciting treatises on venture capital, private equity, mergers and acquisitions.

In my law practice at Kirkland & Ellis, I have long represented many funds and their trade associations, but today I appear to express my own personal views on the appropriate taxation of carried interests.

First of all, we have two systems of taxation in the United States: a corporate system with double tax; and a partnership flow through system where the partners are taxed when the partnership earns income. The partners are then taxed on the income at the capital gain or ordinary income rate by characterizing the income in the partners' hands at the same characterization as in the partnership's hands.

For many decades the Code has conferred a lower tax rate on gain from the sale of a capital asset held more than 1 year: The capital gains rate. Throughout these decades, the Code has never contained an absence of sweat test. For example, assume that Warren Buffet retires from Berkshire Hathaway and invests some of his money in stocks and real estate, working 8 hours a day at his desk. We have a videotape demonstrating that as he worked at his desk picking stocks and real estate in which to invest, he did indeed break a sweat.

Is or should the capital gain that he would otherwise have earned on these long-term investments be turned into ordinary income?

Or, if an innovative entrepreneur like Bill Gates and his investor group start a new computer company, is or should the entrepreneur's long-term capital gain on sale of the computer company's stock be converted into ordinary income because he had many sweaty armpit days?

The Code does not make, and never has made, the absence or presence of activity or ingenuity or even a bit of bodily dampness the test for a long-term capital gain. Nor should we now in my view legislatively adopt a test requiring IRS agents to poke around in Warren Buffett's or Bill Gates' dirty laundry searching for perspirational evidence. Rather, we should not tax carried interest capital gains differently than other capital gains.

When Congress enacts laws picking winners and losers with the tax rates and rules differing by industry, for example, taxing carried interest in venture, private equity and hedge funds more harshly than other types of carried interests and more harshly than other investment gains, the free market is inevitably distorted with great risk of dire, long-term consequences for American economic growth.

Another question: do Steve Schwartzman and his peers make so much money that they should simply be taxed more harshly?

Let me tell you that whenever this august body has enacted punitive tax legislation based on vignettes rather than on careful, macro-economic analysis, our great country has been ill-served. You all recall the famous congressional hearings that found 21 unnamed American millionaires who paid no Federal income tax for 1967 and which resulted in the odious, illogical and counterproductive AMT, an albatross around all our necks ever since.

Over the past 20 years or so, it has not been the big, publicly traded auto companies and airlines that have provided growth in jobs, exports and prosperity. Rather, venture capital, private equity and hedge funds which finance companies have made our economy the most efficient, vibrant and emulated in the world.

I believe that if we now adopt a punitive carried interest bill, the flow of entrepreneurial investments will indeed be reduced. I can't tell you if it will be 10 percent, 20 percent or 30 percent, but I believe that it will be reduced with significant harm to American job growth, exports and business vibrancy. After all, the reason that we have a lower rate on long-term capital gain is to precisely encourage investment of entrepreneurial risk capital in American business to create the jobs, exports and prosperity that we have had in recent years.

[The prepared statement of Mr. Levin follows:]

Prepared Statement of Jack S. Levin, Partner, Kirkland & Ellis LLP, Chicago, Illinois

Mr. Chairman and Committee members, my name is Jack Levin. I teach at Harvard Law School and University of Chicago Law School, am author of a 1,400 page treatise on structuring venture capital and private equity transactions, and am coauthor of a 4,400 page treatise on mergers and acquisitions. In my law practice at Kirkland & Ellis LLP, I have long represented many private equity, venture capital, and hedge funds and their trade associations, although I appear today to express my own personal views on the appropriate taxation of carried interests.

In my brief testimony, and at more length in my written statement, I will try to answer 6 questions:

First question, why do we tax long-term capital gain—that is, to use the Code's verbiage, gain from the sale of a capital asset held more than 1 year—at a lower rate than ordinary income, such as wages or interest income?

Several reasons: By imposing a lower tax on long-term capital gain than on ordinary income, Congress encourages the investment of risk capital in American business. I agree with this approach because the more risk capital invested into American business, the more our companies expand, create jobs and exports, and spread American prosperity.

Another reason for the lower tax rate on long-term capital gain is the recognition that it frequently takes many years to realize gain from a capital investment, by which time inflation has reduced the sales proceeds' real value. Stated another way, much of the so-called long-term capital gain does not really represent true gain because inflation has reduced the proceeds' value.

Second question, when a partnership recognizes long-term capital gain, why is the portion flowing to a carried-interest holder taxed as long-term capital gain?

We have traditionally had two systems of business taxation in this country. The corporate taxation system is very complex with double taxation (once at the corporate level and a second time at the shareholder level when the corporation makes distributions), § 312 E&P calculations, § 302 redemption recharacterizations, § 305 stock dividend rules, § 306 tainted preferred stock, § 368 reorganizations, and 6 mind-numbing interest deduction disallowance rules.

The second system, for partnerships and LLCs, uses a flow-through approach and is designed to be much simpler and more economically rational, with a single level of tax, imposed on the partners when income is recognized at the partnership entity level, by allocating the partnership's income among the partners based on each's economic right to receive such income, with the income allocated to each partner retaining its entity-level characterization as (e.g.) ordinary income or capital gain.

This simpler partnership flow-through tax approach—designed to encourage groups of people to join forces by combining their capital, labor, and know-how to start, build, and expand businesses—has contributed mightily to the vibrancy of America's entrepreneurial economy.

So if a partnership holds stocks or other capital assets for more than 1 year, its gain on ultimate sale of those assets constitutes long-term capital gain in the hands of all the partners, both the pure capital investor and the part-capital part-management carried interest partner.

This is appropriate for a venture capital, private equity, hedge, or real estate fund because the general partners serve as the fund's principals or owners, selecting the fund's investments, sitting on the boards of the fund's portfolio companies, and making the fund's buy and sell decisions (like any owner of an investment), and generally making a substantial capital investment in the fund. General partners are not merely agents of the partnership, who have no capital at risk, merely making recommendations and following the dictates of their investor clients.

Third question, should carried interest partners be taxed at ordinary income rates on their share of the partnership's long-term capital gain because as joint venture managers they are really receiving sweat equity?

For many decades the Code has conferred the lower long-term capital gain rate on gain from the sale of a capital asset held more than 1 year and throughout these decades the Code has never contained an absence-of-sweat test.

For example, assume Warren Buffett retires from Berkshire Hathaway and invests some of his money in stocks and real estate—working 8 hours at his desk every day, including Saturdays, to pick which stocks and real estate to buy, hold, and sell—and assume we have a videotape of his activities showing that on many days he did indeed break a sweat while studying reports and placing buy and sell orders. Is (or should) his long-term capital gain on his stocks and real estate held more than 1 year be converted into ordinary income?

Or if an innovative entrepreneur like Bill Gates and his investor group start a computer company, is (or should) the entrepreneur's long-term capital gain on sale of the computer company's stock be converted into ordinary income because he had many sweaty armpit days?

My point is that the Code does not make, and never has made, the absence or presence of activity and ingenuity—or even a bit of bodily dampness—the test for long-term capital gain, nor should we now legislatively adopt a test requiring IRS agents to poke around in Warren Buffett's or Bill Gates' dirty laundry searching for perspirational evidence.

But if we tax carried interest capital gain differently than other capital gain, isn't that the next step? If venture capital, private equity, and hedge fund managers who invest substantial capital and contribute substantial intangible assets in the form of (e.g.) know-how, reputation, goodwill, contacts, and deal flow are to be tainted by sweat, shouldn't the same rule apply to Warren Buffett and Bill Gates in my examples?

Fourth question, do Steve Schwartzman of Blackstone and his peers make so much money that they should be taxed more harshly?

Whenever this august body has enacted punitive tax legislation based on vignettes, rather than on careful macro-economic analysis, our great country has been ill served. Perhaps the best example is the famous 1969 Congressional hearings that discovered 21 unnamed American millionaires paid no Federal income tax for 1967. The direct result of those hearings is the odious, illogical, and counterproductive alternative minimum tax (or AMT) which has been an albatross around all our necks ever since, and which threatens to affect 25 million taxpayers in 2007 and 56 million by 2017.

Let's not repeat our past tax-legislation-by-vignette approach. Just because some private equity investors, or some athletes, or some thespians, or some computer-company founders make substantial amounts of money doesn't mean it is in America's best interests to impose tax penalties on them without carefully examining the macro-economic ramifications.

Fifth question, will changing the long-standing definition of capital gain to impose ordinary income tax on carried interests in long-term capital gain be harmful for the American economy?

Over the past 20 years or so, it has not been the big publicly traded auto companies and airlines that have provided growth in jobs, exports, and prosperity. Rather it has been the venture capital, private equity, and hedge fund financed companies that have made our economy the most efficient, vibrant, and emulated in the world.

If the carried-interest bill passes, will the flow of venture capital and private equity money into American business be reduced by 10 percent? By 20 percent? By 30 percent? Will American job growth, exports, and business vibrancy be curtailed?

I believe there is substantial risk the flow of entrepreneurial investments will indeed be reduced, with significant harm to our vibrant economy.

So beware the law of unintended consequences and be slow to start down an opaque road if you don't know where it leads.

The basic principle of our free enterprise capitalistic economy is that American employment, growth, and prosperity will be maximized by allowing the free market to operate.

It is the antithesis of the free market when Congress enacts tax laws targeting specific activities and designating winners and losers, for example, taxing carried interest in venture capital, private equity, real estate, and hedge funds more harshly than other types of carried interest and more harshly than other investment gains. When Congress enacts laws picking winners and losers, with the tax rates and rules differing by industry, the free market is inevitably distorted, with great risk of dire long-term consequences for American economic growth.

Sixth question, will a slowdown in venture capital/private equity investing hurt only fat cat venture capital/private equity professionals?

Among the largest investors in venture capital/private equity funds are pension plans and university endowments. Thus, a slow down in venture capital/private equity formation and investing harms not only new and growing American businesses that do not receive the funding necessary to start up, grow, and prosper, but also the millions of American workers whose pension plans are the single largest venture capital/private equity investors and also the millions of American students whose tuition is reduced by their university's endowment profits.

I would be happy to answer any questions.

Mr. LEVIN OF MICHIGAN. Thank you.

Mr. Steuerle.

STATEMENT OF C. EUGENE STEUERLE, Ph.D, CO-DIRECTOR, URBAN-BROOKINGS TAX POLICY CENTER, AND FORMER DEPUTY ASSISTANT SECRETARY OF THE TREASURY, FOR TAX ANALYSIS, REAGAN ADMINISTRATION

Mr. STEUERLE. Mr. Chairman, Ranking Member McCrery, and Members of the Committee, I appreciate the opportunity to appear before you today. I must mention again that each time I appear before Ways and Means, I stand in great reverence, both for its history and its mission.

Let me begin, if you will, with a story. Once upon a time there was a fairly rich society, and in this society was a fairly exclusive club of people who paid low, individual tax rates. Some got into this club because they didn't have a lot of income. Others got in because they didn't realize much of their income. Some belonged because the society's legislature decided to grant a reprieve for multiple layer taxes, but did it in a way that also benefited some who paid almost no tax. Still, others belonged because they figured out how to arbitrage differentials built into the tax system. This last group became very prolific as time went on.

Now, there was another club in this society: those who paid fairly high marginal tax rates on money they actually saved. This club included students going to college, many welfare recipients, those who put their money into bank accounts, and some fairly successful executives. Many people belonged to neither club.

One day, there arose a debate over whether one particular set of members, those who arbitrage both their financial returns and tax differentials, deserved to belong to this first, exclusive club of low tax rates. While there was a very technical debate about the consistency of membership, most of the debate boiled down to the following.

Those who were threatened with loss of membership argued that they were as deserving of membership as other rich Members of the club. Their opponents argued that they were no more deserving than many of those already excluded. Both were right.

Mr. Chairman, Mr. McCrery, Members of the Committee: you have asked that I testify on the basis of my experience as economic coordinator and original organizer of the Treasury tax reform effort that led to the Tax Reform Act of '86 and later as Deputy Assistant Secretary of the Treasury for Tax Analysis. The basic principles of taxation lead to many of the same conclusions today as they did then. Whenever possible, tax differentials should be reduced. These include differentials due both to double taxes and preferences. Today, tax professionals are extraordinarily adept at leveraging those differentials and applying them far and wide.

As a matter of both efficiency and equity, capital gains relief is best targeted where tax rates are high, such as in the case of double taxation of corporate income. The case for providing capital gains relief for carried interest is relatively weak, resting primarily upon whether the administrative benefits of the simple partnership structure needs to be maintained in this arena. It does not rest upon arguments for favoring capital income, entrepreneurs or risk, which can be done in a more efficient manner.

Many people pay high, explicit or implicit rates of tax on their capital income including those whose net worth is in interest bearing accounts, welfare recipients, kids saving for college, and some owners of corporate equity. Relief might be more efficiently and fairly targeted in their direction.

Hopefully, Congress will 1 day turn to these broader reform issues. The reasons stretch beyond equity to economic growth. In particular, the tax arbitrage opportunities the tax system makes available reduce national income and product, encourage too much production of some items and too little of others, and shunt many talented individuals into less productive activities. Perhaps some of those talented individuals are here today. It substantially increases the amount of debt in our economy.

Finally, I suggest that Congress engage the Treasury and the IRS in a much more extensive and continued effort to develop better data about who in society and at various income levels pay multiple taxes and who pay little or no tax at all.

Thank you.

[The prepared statement of Mr. Steuerle follows:]

Prepared Statement of C. Eugene Steuerle, Ph.D., Co-Director, Urban-Brookings Tax Policy Center, and Former Deputy Assistant Secretary of the Treasury for Tax Analysis, Reagan Administration

The views expressed are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders. Portions of this testimony are taken from the author's column, "Economic Perspective," in *Tax Notes* Magazine.

Mr. Chairman and Members of the Committee:

Thank you for the invitation to testify before you today on the taxation of carried interest and its relationship to the broader issue of how a tax system should be designed to meet the goals of equity and efficiency.

You have asked that I testify because of my experience as economic coordinator of the Treasury tax reform project leading to the Tax Reform Act of 1986 and, later, as deputy assistant secretary of the Treasury for tax analysis. In particular, I will address how we succeeded, at least in the view of many, in promoting equity and

improving the performance of the U.S. economy. Note that the 1984–86 work was not really aimed at changing revenues or the progressivity of the tax system. The goals were efficiency and equal justice under the law for people in similar circumstances.

A succinct summary of my conclusions today is as follows:

• Any time Congress creates differentials in taxation, tax professionals are extraordinarily adept at leveraging up those differentials and applying them far and wide.

• As a matter of both efficiency and equity, capital gains relief is best targeted where tax rates are high, as in the case of the double taxation of corporate income.

• The case for providing capital gains relief for carried interest is relatively weak, resting primarily upon whether the administrative benefits of the simple partnership structure needs to be maintained in this arena; it does not rest upon arguments for favoring capital income, entrepreneurs, or risk.

• Many people pay high explicit or implicit rates of tax on their capital income, including those whose net worth is in interest-bearing accounts, welfare recipients, kids saving for college, and some owners of corporate equity. Relief might be more efficiently and fairly turned in their direction.

• Hopefully, Congress will one day turn to broader reform issues, including corporate integration and removing many differentials in taxation. The reasons stretch beyond tax policy to economic growth. For instance, the way that debt is favored over equity not only provides some of the juice for private equity firm transactions, regardless of how they are taxed, but builds up our debt-laden economy.

Differentials in Taxation and Tax Arbitrage

Let me get an important technical distinction out of the way first—the distinction between financial arbitrage and tax arbitrage. Financial arbitrage involves selling lower-return assets and buying higher-return assets. This activity is not confined to hedge-fund managers or private equity firms. Most households and businesses engage in financial arbitrage when they borrow to buy a home or equipment that produces a higher return than the interest rate at which they borrowed.

Tax arbitrage also works off of leverage, but it takes advantage of tax differentials, not necessarily any real productive opportunities. In the case of normal tax arbitrage, it involves the creation of additional assets and liabilities to effectively transfer ownership so that the most highly taxed items are owned by low- or zero-rate taxpayers, and the least highly taxed items are owned by taxpayers facing higher rates. The tax system has provided enormous incentives for creating a debt-magnified economy, so that interest-bearing accounts, bonds, and even implicit debt instruments can be held by non-taxpaying institutions and individuals, while those with higher tax rates then use those loans to hold onto other assets not so heavily taxed.

Sometimes there are also "pure" tax arbitrage opportunities, whereby the taxpayer makes money essentially by borrowing from him- or herself. For instance, many households borrow and pay interest to buy retirement assets. Tax arbitrage explains how the United States can have such high rates of gross deposits in accounts and retirement plans and still have a negative personal saving rate.

Tax arbitrage opportunities are created and enhanced when Congress establishes differential rates of taxation for certain types of income. Some of these differentials work off of the requirement that income be realized before it is taxed; some reflect inaccurate accounting for inflation; others work off of such differentials as capital gains versus ordinary income, debt versus equity, corporate versus noncorporate forms of organization, and taxable versus tax-exempt organizations.

Many partnerships, including private equity firms and hedge funds, figure out ways to write off expenses immediately and in full, while declaring only a portion of currently accrued income or paying a lower rate on realized income. Others sell short or borrow from those in low or zero tax brackets, who, in turn, declare all nominal gains or interest receipts, including fictional income due to inflation, as taxable. Meanwhile, the interest deductions and short sale losses are fully written off by the higher bracket firm members or their clients. Their receipts and other positive declarations of income might be treated as capital gains or avoid taxation because they are not realized.

One reason for the interest carried into this hearing—pun intended—is that tax arbitrage pervades the economy. One doesn't even have to think about it to perform it. Think how common it is for individuals to put money into 401(k) accounts, then later borrow a little more on the house when the cash needed for a vacation is now tied up in the 401(k) account. Similarly, while many hedge fund managers and private equity firm partners might look mainly for financial arbitrage opportunities, at the same time their tax lawyers help them find ways to avoid tax, restructure

deals and the character of their transactions, convert labor to capital gains income, and transfer money into and out of different instruments and tax jurisdictions.

You can quickly see how complex these issues can become. Not surprisingly, the issue of "what to do" correspondingly becomes complicated very quickly. If A is taxed favorably relative to B, who, in turn, is taxed favorably relative to C, then how can you create parity if you only make one change at a time? If you change the law to tax B like A, then C is further disadvantaged. If you instead change the law to tax B like C, then A is further advantaged.

The equity issues are somewhat obvious. If my income is from widget making, which is favorably taxed, and yours from carpentry, which isn't, then the tax laws discriminate against you as a carpenter.

But the efficiency issues are extraordinarily important as well. I want to be absolutely clear. The tax arbitrage opportunities the tax system creates reduce national income and product, encourage too much production of some items and too little of others, shunt many talented individuals into less productive and sometimes nonproductive activities, and add substantially to the debt and other financial instruments in the economy. But when money gets invested for tax rather than economic reasons, the economy gets too much widget making and too little carpentry. Elsewhere, I have attempted to show how tax arbitrage drives the stagnation than accompanies higher rates of inflation.

As a result, most tax theorists, whether liberal or conservative, Republican or Democrat or Independent, believe that reducing and removing differentials helps promote a more vibrant and healthy economy, no matter what level of progressivity or revenues Congress sets. Taxing income equally regardless of source or use was one of the major principles accompanying the Tax Reform Act of 1986.

Capital Gains

Taxing income the same regardless of source, however, is easier said than done. In particular, take the case of capital gains, which is partly at the heart of the debate over carried interest. In a study that Professor Daniel Halperin of Harvard and I conducted years ago, we concluded that *aggregate* capital gains over time could almost all be attributed either to inflation or the retained earnings of corporations. I suspect that recently the bubble market in real estate and stock valuations might lead to additional gains over and above inflation and retained earnings, though these gains could be temporary (and modest when considered over several decades).

In effect, then, much capital income can end up doubly taxed if there are not adjustments for inflation and income already taxed once at the corporate level. The first can be dealt with either by keeping inflation rates low, indexing the tax system for inflation, which is somewhat complex, or, as we do under current law, taxing net capital gains on a realization, rather than accrual, basis. The latter can be dealt with through corporate integration and also taxing on a realization basis. At one time, the corporate integration debate centered mainly on dividends, but researchers have increasingly realized that capital gains can also be double taxed.

In the U.S. tax system, corporate integration has been rejected in favor of simple relief for capital gains and dividends. The consequence is that some capital income is taxed at very low rates—it faces no corporate tax and an individual tax at a favored rate. Through adequate leveraging, some capital income, at least at the margin, is taxed at a negative rate. On the other hand, other capital income can be doubly or triply taxed if realized as accrued and subject to corporate, individual, and estate taxes—not to mention some of the myriad taxes like franchise taxes and property taxes on equipment that states sometimes employ.

Besides inflation and the corporate tax, there is a third justification for capital gains relief. The U.S. tax system is mainly based upon the realization, not the accrual, of income. For many investors, then, realizing capital gains is discretionary, and the capital gains tax is a discretionary tax. Hence, whenever the tax on capital gains is lowered, people recognize more of their capital gains as income. This limits the revenue loss from capital gains relief, especially when tax rates are higher. Even if there were substantial revenues from higher capital-gains tax rates, people can get locked into holding onto their assets for tax rather than economic reasons. Hence, efficiency, too, argues for limiting the extent of "lock in."

Carried Intrest

So what does all this mean when applied narrowly to so-called carried interest and, more broadly, tax reform in general? Nowhere, as best I can tell, do those employing their brain power to make money through carried interests meet the classic justifications for capital gains relief—the avoidance of double taxation because the corporate income has already been taxed or because of inflation, or the prevention of too much lock in.

A very strong case can also be made that carried interest income is more like labor income than capital income, although this distinction is arbitrary for the business owner. In any case, partners can put their own saving aside to achieve capital gains relief on that actual saving. And there are a variety of ways of charging customers for handling their money; I have great faith in the legal community's ability to find ways to allocate real saving by a partnership into tax-preferred form. Moreover, entrepreneurial labor in these types of firms is already favorably treated—in this case, because we do not tax the accrual of partnership interests until they are realized.

Admittedly, it is often difficult to separate capital from labor income, which is one reason for the simplified treatment of partnerships. Don't forget, however, the other side of this coin: some entrepreneurial partners and sole proprietors in small businesses pay labor tax in the form of Social Security and Medicare tax on their capital income. Thus, we don't allow self-employed cleaning people or home-based computer wizards or restaurant owners to reduce their Social Security tax on the basis of an imputed return to their cleaning equipment, computers, or restaurant buildings. They stand in contrast to those who may pay capital gains tax and no Social Security and Medicare tax on some or most of their labor income.

Some arguments against reform in this area need to be rejected. One is that capital taxes need to be kept moderate. There are better ways of keeping capital taxation at reasonable levels. One is corporate integration through forgiveness of capital gains and dividend taxation for income already taxed at the corporate level. Another is a lower corporate tax rate. Congress could also lower taxes for those who provide the real saving—the people who put money in bank accounts and don't borrow elsewhere.

Another misleading argument is that we should subsidize entrepreneurial labor. Again, yes, we should keep tax rates at a moderate level, but the tax system is never very good at defining who provides entrepreneurial labor and who does not. My guess is that, as in most business, some firms are very entrepreneurial at reallocating capital efficiently and some are very entrepreneurial at selling bad products to mislead investors or consumers. Why lower tax on this type of business but tax other entrepreneurial small and large business much more heavily? Moreover, to the extent there are temporarily forgone labor earnings or accrued property interests due to entrepreneurial efforts, these already receive favorable tax treatment, as they are expensed. That is, if I put $100,000 worth of my labor into a firm, and that $100,000 generates expertise and good will that is exchanged for a property interest that will provide cash returns later, then I really have earned $100,000 currently. But the Tax Code nonetheless allows me to write it off as an "investment" and expense the forgone earnings until I later begin to realize the actual cash returns. This labor income, then, is already preferred to earnings subject to tax immediately.

Finally, some suggest that the Tax Code should subsidize risk. This is not a tax policy argument. Some risk is good, some is bad; risk is certainly not good in and of itself. If risk is to be favored, in any case, one wouldn't go into one select area with a lot of risk takers and throw money off the roof to them.

Taxpayers Low and High Tax Rates on Their Capital Income

I don't want to skip over the disparities in tax rates faced by many different types of taxpayers. Some taxpayers do pay fairly high tax rates when they earn additional income:

• A taxpayer in the 25 percent tax bracket whose entire savings are in a bank paying 4 percent interest in a world of 3 percent inflation effectively pays a tax rate of 100 percent on his 1 percent real return.

• Asset tests and rules in many social welfare programs mean that a person saving a few extra dollars can lose thousands of dollars in benefits. Once again, this can translate sometimes to confiscatory tax rates on additional capital income. The additional tax on the saving, measured as a percentage of the return to the saving, is often several hundred percent.

• A student who cuts grass or babysits and saves the money in a bank account for college may pay not only tax on the initial earnings, but, more importantly, find that the loss of Pell grant assistance will be a substantial multiple of any interest earning on the saving. Thought of as a tax on capital income, it would be several hundred percent; thought of as a tax on entrepreneurial labor, the rate could be 67 percent or more.

On the flip side, many other individuals, not just those in firms with carried interest or handling private equity or venture capital, face fairly low tax rates, thanks mainly to tax arbitrage and the failure to recognize income.

• Many people remember Leona Helmsley's famous quip that "Only the little people pay taxes." But what many failed to realize is that many owners of real estate,

such as Ms. Helmsley, effectively achieved their low tax rate through the tax arbitrage made possible by highly leveraged investment. One of the more revelatory moments in the 1984–86 reform process came when a group lobbied against tax reform on the basis that it wanted the progressivity made possible by high tax rates. It turned out that the group represented the tax shelter industry, which liked the high tax rates that applied to their deductions, such as for interest expense.

• The very rich generally pay individual tax rates that are effectively 10 percent or less on their accrued income, since they only occasionally realize this income for tax purposes. Even if capital gains were given no preference, their effective tax rates would remain very low. However, some pay significant corporate tax on their income, depending upon how highly leveraged they are at the individual and corporate levels.

• Another way that some higher-income persons pay lower rates (and an issue for carried interests and private equity) is through avoidance of that portion of the Social Security tax associated with Medicare—the Hospital Insurance tax. As noted, many sole proprietors and partnerships pay this tax on all their returns from these businesses, even returns that might be thought of as returns to capital. Meanwhile, those who get such income counted as capital or capital gain income avoid this tax altogether for that income.

Broader Reform Issues

Given all the differentials in the tax system, it is easy for almost anyone to argue that someone is making out even better. The complication is that serious analysis requires recognizing that lowering one person's relative tax burden by definition means raising another's. Taxes are a price of government, and their aggregate level is set largely by the level of expenditures of government, not by current collections.

The basic principles of taxation lead to many of the same conclusions today as when we were constructing major tax reform two decades ago:

• Whenever possible, tax differentials should be reduced. This is not an issue of progressivity or revenues but of efficiency and equal justice under the law for those in equal circumstances.

• Removal of differentials should not mean the creation of new differentials through double taxes. Efforts still need to be expended on removing double taxation of capital gains and dividends and avoidance of a high inflation tax or subsidy for debt.

• If the tax on capital income is to be lowered, relief should be concentrated broadly, as through corporate integration or a lower corporate tax rate.

• Labor income should be taxed similarly regardless of source.

• The Tax Code should not favor debt over equity. Currently, this provides some of the juice can generate profits for private equity firms without any necessary gain to the economy from the transactions—regardless of what tax rate the partners pay.

• Given the very high tax rates many low- and moderate-income taxpayers face, we probably ought to pay more attention to the taxation of their assets and returns from capital. The reasons for the opposite, upside-down focus on providing relief mainly for the richest and most successful members of society seems driven more by lobbying dollars than economic considerations.

Finally, let me offer one additional suggestion for which there is also an analogy with tax reform days. In the mid-1980s, the Treasury engaged the IRS in studies of the various ways income was being sheltered from tax. Congress found these data useful in considering what changes it would undertake. As I have noted, tax professionals exhibit an enormous ability to take advantage of differentials in taxation. I suggest that Congress ask the Treasury and IRS to engage in a much more serious and continual effort—combining policy, statistics, and enforcement personnel—to expose who, at various income levels, pay multiple taxes and who pay little or no tax at all.

Mr. LEVIN OF MICHIGAN. Professor Jones.

STATEMENT OF DARRYLL K. JONES, PROFESSOR OF LAW, STETSON UNIVERSITY COLLEGE OF LAW

Mr. JONES. Thank you.

So, there's going to be a lot of paperwork and documents in the record after this hearing is over with, and those papers are filled

with theories, opinions and even dire predictions. But I'd like to point out one thing that we know absolutely for sure.

We know that somewhere in America is a family, perhaps with a son or daughter fighting in Iraq or Afghanistan, making $70,000 a year and paying tax at a marginal rate of 25 percent. We also know for sure that there is a fund manager somewhere, who according to some press reports, made about $684 Million in 1 year and paying taxes at 15 percent.

A recent paper published by Professor Michael Knoll of the University of Pennsylvania suggested or concluded that if we taxed secured interest the same way that we taxed a regular worker, an average American worker, we would obtain between Two and Three Billion Dollars a year. In preparing for my testimony, I tried to come up with the starkest example of what that really means in human terms, and I found in Internet that it costs about $7,500 to fully equip a soldier or marine with full body armor to protect him or her against hot shrapnel going into her Adam's apple or into his groin, it costs about $7,500.

That means that it costs a little bit less than $1 Billion per year. So, that's what it would mean if we taxed fund managers the same way we tax other service providers. I might add that it's never been the case, as Prof. Levin has pointed out, that sweat equity disqualifies an investor of previously taxed capital from the capital gains rate. But neither has it been the case that sweat equity alone grants you access to the preferential tax rates that are contained in the capital gains taxation system.

You know, when I was preparing for my testimony, I really got indignant about some of the arguments that are being made, particularly by people in the fund management industry, because I thought that they were extremely, intellectually dishonest. I was prepared, really, to come in and pound the podium and call them a bunch of liars and so forth. But I'm heartened by some of the testimony I've heard today, particularly from Mr. Shapiro. On your next panel, Mr. Hendry and Mr. Stanfield, who will admit that even after their 20 years of experience they know that what their doing is earning money the same way you and I are earning money, and that is through their human capital.

Closing the carried interest loophole is not an attack. It's not a Trojan horse attack on the capital gains rate. This is what Republican Senator Grassley says about the carried interest tax scheme. He says that this isn't the carried interest tax scheme is an attack on the integrity of the capital gains tax rates.

If we allow the carried interest tax scheme to continue, we're allowing the opponents of capital gains taxation a legitimate opportunity to attack the integrity of the tax. That's what Republican Senator Grassley said. So, if there is a Trojan horse attack on the carried interest, the people inside that horse are a bunch of very dangerous fund managers, not a bunch of Democrats or even Republicans who are trying to attack the capital gains rate.

A couple years ago President Bush appointed a Presidential commission to talk about tax reform. That Presidential commission stated that every time that we grant a special privilege for one group of taxpayers, it costs everybody else a lot of money. That's what's going on right now. The Tax Code is about two things: effi-

ciency and fairness. It doesn't take a PhD in Economics to see how unfair it is that an average working family pays taxes at 25 percent and somebody who's making a lot more money in much nicer digs is paying taxes of 15 percent.

Since this issue has come to the attention of the American people, there's been a lot of theory and attempts at trying to justify this inequity [continuing]. I think that Congress will soon enough see through the smoking mirrors and come to the right conclusion and tax the carried interest as ordinary income just like every other worker.

Thank you very much.

[The prepared statement of Mr. Jones follows:]

Prepared Statement of Darryll K. Jones, Professor of Law, Stetson University College of Law, Gulfport, Florida

Chairman Rangel, Ranking Member McCrery and Members of the Committee:

Thank you for this opportunity to talk to the committee regarding an important issue of tax policy and fundamental fairness. By now, most people are acutely aware of the problem with which this Committee is rightly concerned. Most of the debate regarding the taxation of carried interests has been articulated in rather dry academic terms without focusing on the real human impact. Before I, too, launch into a philosophical discussion, I want to describe the obscene problem in terms understandable to real American families. A modest American family making $70,000 per year, and having one son fighting in Iraq with other average American men and women, pays taxes at a 25 percent marginal rate.[1] Those taxes help fight the wars we decided are necessary to fight.

On the other hand, a fund manager making more than $3 or $4 million per year, with means plenty sufficient to keep his son or daughter out of Iraq or Afghanistan pays taxes at a maximum rate of 15 percent. The only study to date regarding the revenue loss occasioned by fund manager manipulations states that if fund managers were taxed just like average American families—not a tax hike—the government would raise between $2 and $3 billion dollars annually.[2] To understand what that really means, consider that it cost about $7,500 (the price of a small, late model used car) to equip each soldier, sailor, and marine fighting in Iraq or Afghanistan with full body armor—armor that protects not only the chest and back, the base of the neck, the buttocks and the groin. That is less than $1 billion dollars to adequately equip our fighting forces against flying shrapnel. With the money obtained if fund managers simply paid their fair share we could save many of those fighting for the very system fund managers so gleefully exploit.

There are three primary reasons why we tax some income (i.e., "ordinary income") at comparatively higher rates than capital income. My testimony in this regard is neither new nor groundbreaking. Indeed, every person who has ever really thought about capital gains taxation knows of these reasons, though many people disagree that they justify a lower tax rate on some income than others.[3] Assuming the reasons are valid, they would nevertheless not in any way justify the application of capital gains rates to service compensation earned by fund managers.

The first reason pertains to the economic definition of income and the reasonable belief that only real economic gains should be taxed. Suppose a taxpayer earns $100 (net after tax) during a time when one year inflation is 6 percent. The $100 is previously taxed income and, of course, should not be taxed again. If the taxpayer buys property for $100, and after one year sells the property for $106, she will reap and pay tax on $6.00 nominal gain. This, despite the fact that she is no richer than when she invested the $100 in the property one year ago. She has a nominal gain

[1] Compare, Nancy Duff Campbell, *Close Loophole Designed To Benefit Hedge Fund Managers*, The Miami Herald, August 21, 2007, *available at http://www.miamiherald.com/851/story/209866.html*. (noting that something is "deeply wrong" when a single mother earning just over $40,000 per year is in a higher tax bracket than millionaire bosses at hedge funds).

[2] Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income*, University of Pennsylvania Law School Research Paper No. 07–32, *available at http://www.law.upenn.edu/academics/institutes/tax/index.html*.

[3] Some have proposed, for example, that rather than engender the complexity and avoidance provoked by capital gains taxation, we should simply "index" basis so that it is adjusted by the rate of annual inflation.

under IRC 1001 but no economic gain. Because of inflation, her $106 one year later gives her no more purchasing power than she had one year earlier. Thus, taxing the $6.00 nominal gain amounts to an additional tax on the same accession to wealth. The upshot of this economic result is that the taxpayer who earns $100 is better off immediately consuming it, instead of saving it long term presumably in a manner that generates greater societal benefit. That is, the tax on capital encourages immediate over-consumption.

The second reason for the capital gains preference relates to the taxpayer who wishes to reinvest her previously taxed income in a better place but declines to do so because she knows she will be taxed on the transition from one investment to another. If, for example, the taxpayer who earned and invested $100 during a period of 6 percent inflation decides she no longer wants to invest in eight track tape players because MP3's represent better technology, she would have to sell her investment in eight track tape players, pay a tax (largely on inflationary gain) and then reinvest the net amount. The tax imposed on the sale of the eight track investment might very well discourage her from withdrawing from a burned out investment and using the previously taxed income to invest in a more profitable and socially beneficial investment. That is, she might continue her original investment in the manufacture of eight track tape players when MP3 are better solely because of the tax cost occurred by shifting to a better investment. This latter point is referred to as the "lock-in" effect.

Implicit in both of these first two examples is that there has been a beneficial "savings"—referred to economically as "investment"—of *previously taxed income*. A later tax, again largely on inflationary gain, amounts to a second tax on the same income and some people find this inherently unfair for good reason.

Neither of the first two justifications for capital gains taxation applies to the tax that ought to be imposed on the carried interest. In the typical case, fund managers have not ever been taxed on income subsequently invested in long term assets, such that we should be concerned about the deleterious effect of taxation on nominal as opposed to real economic gain.[4] Fund managers invest untaxed human capital—what Ms. Mitchell referred to in her testimony before the Senate Finance Committee as "sweat equity"[5]—not previously taxed financial capital. The tax on human capital is a single tax, since we do not tax people on their potential to earn. If we taxed people on mere earning potential, and then again upon the financial realization of that potential, we should rightly be concerned about the double taxation. We do not tax earning potential so there is no double taxation, nor is there a prior taxing event that would encourage people to "lock up" their earning potential to avoid a second tax. We don't have to worry that people will not get a job, particularly when the market compensates them so handsomely for doing so. Clearly, then, none of the long accepted policy reasons justifies the application of capital gain tax rates to fund manager compensation.

A third common, but less agreed upon reason for taxing the income from capital at lower rates is referred to as the "bunching effect." The bunching problem refers to the fact that a taxpayer who holds an investment long term will pay a higher tax than if she bought and sold the same asset over and again on a short term basis. A simple example helps demonstrate the problem. Assume, for example, that a taxpayer pays $100 for property and the property's value increases by 10 percent annually. If the 10 percent increase were taxed annually, the taxpayer would pay

[4] To the extent fund managers make capital contributions from previously taxed or specifically exempted income, they should be granted capital gain treatment on their long term yields because in that instance the double tax or lock-in effect applies. HR 2834 would provide such treatment. Senators Baucus and Grassley have introduced a bill to tax publicly traded fund management partnerships as corporations. Members should not confuse the discussion of the proper taxation of carried interests with the question of the taxation of a publicly traded management company, though some of the same people would be affected by both initiatives. Whether or not the publicly traded management company is taxed as a corporation, individual fund managers will continue to be compensated by means of carried interests in other partnerships that hold the investments that the publicly traded company manages.

[5] *See http://www.senate.gov/~finance/hearings/testimony/2007test/071107testkm.pdf.*

a total of $6.00 in tax assuming a flat rate of 10 percent on annual income of less than $10 and 25 percent on annual income over $50. Table 1 shows the outcome:

Table 1: The Bunching Problem

Year	Appreciation	Value	Annual Tax on increase
1	10	100	0
2	11	110	1
3	12.1	121	1.1
4	13.3	133	1.2
5	14.6	146	1.3
6	16.0	160	*1.4*
Total tax on $60 appreciation at 10 percent per year			**$6**

If the taxpayer held the asset long term and sold it for $160 six years later, her $60 gain would be "bunched" and her tax would be $15.00, an increase of $9.00 merely because the taxpayer held the asset longer and realized all of her gain in one year. Lowering the tax on $60 long term gain to 15 percent alleviates some, but not all of the bunching problem. The tax in that case would be only $9.00.

The bunching problem, too, is entirely inapplicable to the taxation of carried interests, primarily because bunching refers to the creeping appreciation in property value and fund managers are simply investing labor—just like most other average Americans who receive no tax break for an alleged bunching problem. In any event, if bunching were a solid justification for taxing fund managers at lower rates, it would necessarily require lower rates for all service providers whose income is taxed at more than the lowest marginal rates.

The remainder of my written testimony debunks two commonly raised justifications—more like campaign slogans—used by fund managers in an effort to retain their special tax break. The first asserts that capital gains taxation is justified by the alleged risks and social rewards that fund managers assume and generate, respectively. The second attempts to justify capital gains taxation of fund managers because of the *labor* that precedes the investment of capital. Neither of these justifications withstands the light of close scrutiny.

The notion that normal or even enhanced risk-taking justifies the application of capital gains tax rates to fund managers is both novel and bizarre. The notion proves too much.[6] Every entrepreneur is a risk taker but only entrepreneurial investors of *previously taxed income* are taxed at lower rates, for the reasons discussed above not because they are risk takers. Every economic activity presupposes risk so the fact that fund managers undertake risk is insufficient to justify capital gains taxation. If Tiger Woods, for example, does not win (or place within the top performers), he receives no compensation for his efforts. When he wins, he is taxed at ordinary rates. When Tiger Woods' competitor wins—in an industry with much greater risk than venture capitalism, given the presence of Tiger Woods—the competitor's demand for taxation at capital gains rates would not be justified by the fact that Tiger Wood's presence made the investment of human capital by all other competitors extraordinarily risky in an economic sense. The market itself compensates for the decision to undertake the extraordinary risk—via extraordinary compensation—and so there is no reason to grant a tax subsidy. The more important point is that risk taking has nothing to do with capital gains taxation. Every investment—whether of human or financial capital—involves risk. A theory that capital gains taxation is appropriate for risk taking proves too much and is nothing more than a selective plea for lower tax rates for certain activities.

The latter assertion is refutable only to the extent capital gains taxation is conceptualized as a subsidy (rather than as a remedy) and then only to the extent a subsidy is necessary to spur "irrational" but nevertheless socially necessary economic behavior.[7] Two examples demonstrate the inappropriateness of a subsidy ra-

[6] The fact that fund managers voluntarily structure risk into their compensation scheme has no relevance to capital gains tax rates. "So are the incomes of movie actors, the royalties of authors and the prize winnings of golfers—none of which is treated as capital gains" [nor should they be]. Alan S. Blinder, *The Untaxed Kings of Private Equity,* New York Times, Section 3, page 4 (July 29, 2007).

[7] There are various assertions that capital gains taxation subsidies greater wealth for the wealthy. I take no position on these assertions but instead accept the notion that capital gains taxation remedies the double tax and lock-in effect.

tionale as a justification for taxing fund management compensation at capital gains rates. The first pertains to the research and development tax credit. The financial cost (i.e., the risk) of research and development is so high that rational people ought to spend their labor and money elsewhere.[8] The research and develop tax credit effectively lowers the tax rate—and thus the risk—on labor and income directed towards a certain needed and socially beneficial activity that would otherwise not occur in the market. Providing a lower tax rate via a credit encourages highly risky but nevertheless socially necessary labor and capital not sufficiently provided by market incentives. A closer example involves serving in combat. The tax rate on combat pay (zero percent) is lower than the tax rate on other services.[9] Going to combat is a risky, irrational behavior with such little hope of financial reward that we should expect it never to occur without something to offset the risk. I am here speaking only in the economic terms the proponents of capital gain taxation have used in the debate; I am not referring to the higher callings that motivate my younger brothers, my niece and others like them to engage in combat. Nevertheless, in an economic sense, there is insufficient hope of market reward to motivate combat services. It is only when we can make that conclusion—that the market insufficiently provides needed services—that non-ordinary taxation on services such as that performed by fund managers is justifiable. We cannot make that assertion to service as a fund manager because the *hope* of financial reward is so high that the socially beneficial behavior will inevitably occur in sufficient quantities.

Moreover, removing market risk that fund managers take—if indeed, they really are at risk—by granting tax preferences would distort the market by causing more people to seek jobs as fund managers rather than performing services in other areas in need of human capital. Softening that potential risk punishment via a tax break encourages irrational risk-taking and ought to be tolerated only when there is a demonstrable societal benefit not otherwise provided via the market. As fund manager compensation figures show, the market more than adequately spurs the risk-taking that fund managers indulge when they put their service compensation at the demonstrably benevolent mercy of investment funds. Any losses incurred by fund managers serve only to discipline the market by discouraging too much risky behavior that would harm the economy.

Ms. Mitchell's testimony during Carried Interest I can be characterized as sentimental sophistry at best. It reminded me of Reagan's "morning in America," Bush, Sr.'s "a thousand points of light," and just to be bipartisan about it, Clinton's "don't stop thinking about tomorrow." She described such wild successes as Google, YouTube, FedEx, and Ebay as evidence of the legitimacy of capital gains taxation for services. In each of those examples, though, there was sufficient hope of astronomical market reward such that any non-confiscatory level of taxation would be appropriate. Unlike research on new drugs, or service in combat, the real risks were far outweighed by the potential reward. There was at least enough hope that the true investors of previously taxed capital could *easily* attract the sweat equity—previously untaxed, by the way—necessary to put other peoples' previously taxed capital to work. Some of the witnesses during Carried Interest II conceded this point but responded by arguing that in the absence of U.S. capital gain treatment, investors of previously taxed capital would invest their money in offshore funds where fund manager compensation is cheaper. The easy answer to that is, "all well and good." If investors can find the same labor at cheaper prices, domestically or overseas, it is not the Tax Code that is diverting capital to foreign markets. It is instead the overpriced demands made by domestic fund managers. Chyrsler, Ford, and GM have to compete with cheaper sources of labor, why shouldn't fund managers have to do the same, and in doing so, they save more of their pension fund or charitable foundation for their intended purposes. The argument, then, that capital gains taxation is necessary to maintain domestic capital domestically is both anti-competitive and protectionist. At bottom, the capital gain preference is plea subsidize the investment management industry. A tax subsidy, though—either via exemption or merely lower tax rates—is unnecessary when the rational hope of getting rich is sufficient to spur the services upon the industry is dependent. The rational, realistic "hope," not the guarantee, of market rewards, spurs needed economic service and renders

[8] IRC 41 (1986). "The intent of the R&D tax credit was to encourage R&D investment by the private sector. Congress believed that the private sector was not investing enough in research and development. Legislative history indicates that Congress believed that the private sector's lack of investment in research and development was a major factor in the "declining economic growth, lower productivity, and diminished competitiveness of U.S. products in the world market." Belinda L. Heath, *The Importance of Research and Development Tax Incentives in the World Market, 11* MSU–DCL J. Int'l L. 351, 352–53 (2002).

[9] RC 112 (1986).

tax preferences superfluous. If the risk of reward outweighs the risk of loss, such that the activity will occur in optimal quantities anyway, a tax subsidy is an extremely unwise use of tax dollars. Indeed, providing a tax subsidy when the market provides the sufficient hope of reward so that the behavior would have occurred in sufficient quantities is against societal interest. They generate an oversupply of the thing subsidized. Moreover, tax subsidies are not limitless. The tax subsidy—the *unnecessary* tax subsidy—spent to encourage labor already in sufficient supply could have been better spent for more research and development or higher combat pay.

Finally, and with due respect, Mr. Solomon's example during Carried Interest I regarding a business built with the combination of labor and capital proves the opposite of what he intended because it omits necessarily implicit facts. The example states:

Entrepreneur and Investor form a partnership to acquire a corner lot and build a clothing store. Investor has the money to back the venture and contributes $1,000,000. Entrepreneur has the idea for the store, knowledge of the fashion and retail business, and managerial experience. In exchange for a 20 percent profit interest Entrepreneur contributes his skills and know how [i.e., human capital or services]. Entrepreneur and Investor are fortunate and through their combination of capital and efforts, the clothing store is successful. At the end of 5 years, the partnership sells the store for $1,600,000, reflecting an increase in the going concern value and goodwill of the business. Entrepreneur has $120,000 of capital gain and Investor has $480,000 of capital gain.[10]

Note that the example asserts that the appreciation is attributable solely to the increase in going concern value and goodwill. Going concern value and goodwill could not possibly have been generated without previous realization and recognition of ordinary income via the sale of inventory and the performance of services. If the partnership is sold with inventory or accounts receivable [e.g., for services] on hand, the first part of the gain will be correctly taxed at ordinary rates, regardless of whatever value the parties ascribe to going concern or goodwill.[11] If instead, the store previously sold all of its ordinary income assets—haute couture clothing and services, for example—without having ever distributed a portion of the gains to the service partner, the service partner would have nevertheless recognized ordinary income,[12] before being granted access to the capital gains rates applicable to the sale of the partnership interest.[13] This would, of course, be appropriate because the undistributed, previously taxed ordinary income would be economically analogous to *previously taxed income invested in long term property.*

In the most fanciful of all desperate attempts to retain an unjustified tax break, David Weisbach opines that capital gains taxation of carried interest is justified because of the *labor* that goes into the decision where to invest one's previously taxed capital. Weisbach states that fund managers should continue to enjoy capital gain treatment for services because:

- the labor involved in private equity investments is the same type of labor
- that is intrinsic to any investment activity. Sponsors [Weisbach avoids the more accurate label, "managers" for good reason] select the investments, arrange the financing, exercise control rights inherent in ownership of the portfolio companies, and eventually decide when to dispose of the assets. If the performance of these tasks were sufficient to deprive sponsors of capital gains treatment, capital gains treatment would not be available to any investor.[14]

This argument, like that pertaining to risk assumption, proves entirely too much. It is indeed true that investors of capital aren't "deprived" of capital gains preference merely because they labored to find a good place to invest previously taxed capital. It is just that the argument is wholly beside the point. Of course the expenditure of labor is insufficient to deprive the yield from previously taxed wealth of capital gains tax rates, but so too is the expenditure of labor insufficient to *obtain*

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[10] http://www.senate.gov/~finance/hearings/testimony/2007test/071107testes.pdf.

[11] IRC 751 (1986).

[12] IRC 702(b) (1986).

[13] Mr. Solomon's example actually only demonstrates a timing issue—whether the service partner should recognize ordinary income upon receipt of the partnership profit interest, or as profits are actually earned. I have stated elsewhere that it is at least tolerable to defer recognition until profits are actually earned by the partnership. Darryll K. Jones, *Taxing the Carry,* 115 Tax Notes 501 (2007). Other commentators have made convincing arguments that ordinary income should be recognized upon the grant of the profit interest. *See* Lee Sheppard, *Blackstone Proves Carried Interests Can Be Valued, 2007 TNT 121–2 (June 20, 2007).* In any event, there is no conversion tolerated in this example.

[14] Weisbach's paper can be found at http://www.privateequitycouncil.org/wordpress/wp-content/uploads/carried-interests-07-24-07-final.pdf. The paper was "funded" by the Private Equity Council and should therefore not be mistaken for disinterested academic discussion.

capital gains taxation. We are talking about the right to *obtain*, not *retain* capital gains taxation.[15] It is only the investment of capital that obtains and retains capital gains rates, for the reasons stated above; all labor preliminary to that investment is wholly irrelevant and indeed insufficient. That's why the same type of labor involved in the selection of a job by a plumber or the determination of which inventory a mom and pop grocery store should buy wholesale does not make compensation from the job or retail profit from the sale of inventory taxed at capital gains rates.

Mr. LEVIN OF MICHIGAN. Thank you.

Professor Fleischer.

STATEMENT OF VICTOR FLEISCHER, ASSOCIATE PROFESSOR OF LAW, UNIVERSITY OF ILLINOIS COLLEGE OF LAW

Mr. FLEISCHER. Thank you for inviting me here to present my views.

The current tax treatment of carried interest is problematic because it treats labor income as if it were investment income. By taking a portion of their pay in the form of partnership profits, fund managers defer income derived from their labor efforts and convert it from ordinary income into capital gain.

This quirk in the tax laws is what allows some of the richest workers in the country to pay tax on their labor income at a low rate.

I will make three quick points. First is to elaborate on this idea that carried interest properly understood is labor income and not investment income. Carried interest is incentive compensation received in exchange for managing other people's money.

From a business point of view, carried interest works well. It aligns the incentives of the fund managers and their investors. If the fund does well, the managers share in the treasure. This alignment of interest concept, which works well for business purposes, does not magically transform that compensation into capital gain. It is still compensation for services rendered. Fund managers share in the appreciation in the fund, but they bear little downside risk. Carried interest thus diverges from the tax treatment of other compensatory instruments. Carried interest is treated more favorably than partnership capital interest, corporate stock or stock options.

Carried interest is the single most tax efficient form of compensation available without limitation to highly paid executives.

The second point is that the partnership tax rules were designed with small business in mind, not billion dollar investment funds. I will talk a second about how I think we got to where we are today.

Various changes in the capital markets have taken a modest subsidy from mom and pop businesses and turned it into a subsidy for large investment firms. These changes in the capital markets include massive inflows of capital into the private equity sector, an increase in the number of tax exempt investors, adoption of new investment strategies that have increased demand for these alternative asset managers, and the aggressive conversion of management fees into carried interest.

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[15] If an investor places his capital at risk and then personally rides roughshod over her managers, she is not thereby "deprived" of capital gains rates on the gains derived from the investment of her profits.

Congress should respond to these changes in the investment world by bringing the law up to date.

My third and final point is that there is widespread agreement among tax professors and economists that the status quo is problematic. There is ample room for disagreement about the scope and mechanics of different reform alternatives, but most of us view current law as troubling. It offends basic principles of sound tax policy like seeking a broader tax base which allows for lower tax rates overall. That is something that most tax professors and economists agree on, broad-based lower rates overall.

By taxing asset management activities at a low rate, we must tax other activities of equal social and economic value at higher rates. This is neither fair nor efficient.

Among the various reform alternatives, H.R. 2834 makes a lot of sense. It provides a simple baseline rule that would treat carried interest as ordinary income; by taxing carried interest like other forms of compensation, it will improve economic efficiency and discourage wasteful gamesmanship.

These changes would also reconcile private equity compensation with our progressive tax rate system and widely held principles of distributive justice.

Obviously, there are a lot of details that I have written about elsewhere and are in my testimony. I look forward to answering your questions. Thank you.

[The prepared statement of Mr. Fleischer follows:]

TESTIMONY ON TAXING PARTNERSHIP PROFITS IN PRIVATE EQUITY FUNDS

HOUSE OF REPRESENTATIVES COMMITTEE ON WAYS AND MEANS

Victor Fleischer

Associate Professor
University of Illinois College of Law

September 6, 2007

COMMITTEE ON WAYS AND MEANS

TESTIMONY ON TAXING CARRIED INTEREST

Victor Fleischer*

Thank you for inviting me here today to present my views.

Summary. Current law creates a tax planning opportunity for private equity fund managers who receive the industry-standard "two and twenty" compensation for running a fund (i.e., a two percent management fee and twenty percent profits interest). By taking a portion of their pay in the form of partnership profits, fund managers defer income derived from their labor efforts and convert it from ordinary income into long-term capital gain. This quirk in the tax law is what allows some of the richest workers in the country to pay tax on their labor income at a low rate.

Changes in the investment world have transformed this tax issue from a byzantine academic issue into a pressing matter of social policy. Congress never intended to allow investment fund managers to enjoy this tax subsidy. The fact is that when Congress enacted the partnership tax rules in 1954, it could not have foreseen the changes that have created the situation we see today. The partnership tax rules were designed with small business in mind, not billion-dollar investment funds. The changes in the capital markets include massive inflows of capital into the private equity sector, an increase in the number of tax-exempt investors like pension funds and endowments, the adoption of portable alpha strategies by these institutional inves-

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* Associate Professor, University of Illinois College of Law. I thank David Kamin for his assistance in editing these remarks. I discuss these issues in more detail in *Two and Twenty: Taxing Partnership Profits in Private Equity*, N.Y.U. L. REV. (forthcoming 2008). The article is available in draft form at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=802440.
I welcome comments and suggestions at victor.fleischer@gmail.com.

tors, the adoption of the carried interest structure by other financial intermediaries, and the aggressive conversion of management fees into carried interest. Congress should respond to these changes in the investment world by bringing the law up-to-date.

While there is ample room for disagreement about the scope and mechanics of different reform alternatives, there is widespread agreement among tax professors and economists that the status quo is an untenable position as a matter of tax policy. Among the various reform alternatives, H.R. 2834 makes a lot of sense, providing a baseline rule that would treat carried interest distributions as ordinary income. By taxing carried interest distributions to fund managers in a manner that more closely matches how our tax system treats other forms of compensation, H.R. 2834 will improve economic efficiency and discourage wasteful regulatory gamesmanship. These changes would also reconcile private equity compensation with our progressive tax rate system and widely-held principles of distributive justice.

Labor income vs. Investment income. The first point that I will make concerns the difference between labor income and investment income.

So long as we have a difference in the rates at which we tax capital gains and ordinary income, we have no choice but to pay attention to the lines that distinguish between the two. When capital gains are taxed at lower rates, as they are now, taxpayers have an incentive to restructure their activities to make their labor income look like investment income. While carried interest has elements that make it sound like an investment – it's risky, it's tied to the appreciation of a capital asset – it is better characterized as compensation.

The carried interest that fund managers receive is an incentive fee received in exchange for managing assets on behalf of investors. The carried interest aligns the interests of the fund managers and their investors: If the fund does well, the managers share in the treasure. But the fact that the fund managers do well financially if the assets appreciate does not somehow magically transform what they receive into a return on investment capital. The fund managers share in the appreciation in the fund, but bear little of the downside risk. The carried interest is received in exchange for services, not investment capital.

This conversion of labor income into capital gain is contrary to the general approach of the tax code, and it diverges from the treatment of other compensatory instruments. Partnership profits interests are treated more favorably than other economically similar methods of compensation, such as partnership capital interests, restricted stock, or at-the-money nonqualified stock options (the corporate equivalent of a partnership profits interest).[1] A partnership profits interest is, under current law, the single most tax-efficient form of compensation available without limitation to highly-paid executives.

Congress has dealt with this labor vs. investment issue before, in section 83 of the tax code. From an academic perspective, the two code sections that cannot be reconciled conceptually are section 702, which defines the character of income received by partners, and section 83, which determines the timing and character of income received by employees. In the context of corporate stock, section 83 puts executives to a choice: they may make a section 83(b) election and recognize income immediately on the current value of the property, or they can wait-and-see. If they make the election, any further gain or loss is capital gain or loss. If they wait-and-see, however, the character of the income is ordinary.

In the partnership context, on the other hand, we do not require partners to make a choice. The usual import of section 83 is, as a practical matter, disregarded. Partners can wait-and-see, and yet the character of the income when it is realized later is capital gain, not ordinary income. Because a profits interest in a partnership is difficult to value, I do not believe it is practical to try to force a valuation at the moment a carried interest is granted. Instead, the logical solution is to change the character on the back end when profits are received, which is what the House Bill does.

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[1] The tax treatment of carry is roughly equivalent to that of Incentive Stock Options, or ISOs. Congress has limited ISO treatment to relatively modest amounts; the tax subsidy for partnership profits interests is not similarly limited. In both cases, the executive receives the benefit of deferral and conversion into capital gain, while the employer loses the benefit of a current ordinary deduction for compensation. Because, in the case of private equity funds, the "employers" are mostly tax-exempt investors, the loss of the benefit of a current ordinary deduction in less important than in the context of a corporation issuing ISOs. Congress has limited ISO treatment to options on $100,000 worth of underlying stock, measured on the grant date, per employee per year. See § 422(d).

Why now? The second point that I want to make has to do with why Congress should address this issue now.

For some members, the most compelling point is simply one of distributive justice. This quirk in the partnership tax rules allows some of the richest workers in the country to pay tax on their labor income at a low effective rate. While the high pay of fund managers is well known, the tax gamesmanship is not. This simple fact will suffice to persuade many of you that changing the tax law is the only just response.

For other members, however, it may be more helpful to expand on how we got to where we are. The relevant code sections and regulations have actually been stable over time. The key development has been the growth and professionalization of the private equity industry. The private equity revolution has shaped the source of investment capital and spurred an increase in demand for the services of intermediaries. These institutional changes have put increasing pressure on the partnership tax rules, which were designed with small businesses in mind.

In the 1980s, following a change in pension law, institutional investors such as pension funds, foundations, and endowments began to include alternative assets like venture capital funds, private equity funds, and hedge funds in their portfolios. The most powerful investors, such as large public pension funds and university endowments, may invest as much as half of their portfolio in alternative assets. This shift in the source of investment capital creates some tax planning opportunities. Many of these institutional investors are tax-exempt; substitute taxation is not available as a backstop to prevent exploitation of gaps in the tax base created by the realization doctrine and conversion of ordinary income into capital gain.

More recently, as the industry has professionalized, the demand for private equity has increased. Smaller institutions, family offices, and high net worth individuals now seek access to the industry. Funds-of-funds and consultants have stepped in to provide these services. In addition to providing increased access to funds, these intermediaries screen funds to find the best opportunities and monitor the behavior of managers in the underlying funds. In exchange, they often receive a share of the profits – a carried interest of their own.

Each year, more and more financial intermediaries take advantage of the tax treatment of two and twenty.

Additionally, fund managers have become more aggressive in their regulatory gamesmanship. Fund managers receive management fees, usually a fixed percentage of committed capital, in addition to the carried interest. (This fee, often 2%, is the "two" in "two and twenty.") These fees are normally taxed as ordinary income. Fund managers, however, have become aggressive in strategically converting these fees into additional shares of carried interest.[2] This tax planning strategy defers income and may ultimately convert labor income into capital gain. Some fund managers opt to reduce the management fee in exchange for an enhanced allocation of fund profits. The choice may be made up front, triggered upon certain conditions, during formation of the fund; in other cases the managers may reserve the right to periodically waive the management fee in exchange for an enhanced "priority" allocation of fund profits during the next fiscal year of the fund.

Lastly, the problem warrants renewed attention because the treatment of a profits interest in a partnership represents a striking departure from the broader design of executive compensation tax policy. Economically similar transactions are being taxed differently. Investors structure deals to take advantage of the different tax treatment. Generally speaking, this sort of tax planning is thought to decrease social welfare by creating deadweight loss, that is, the loss created by inefficient allocation of resources. Specifically, the tax-advantaged nature of partnership profits interests may encourage more investments to take place through private investment funds, which are taxed as partnerships, rather than through publicly-traded entities, which are generally taxed as corporations. Choices about how to structure transactions should be made based on which form would allow for the greatest economic productivity—and not based on which form is more tax-advantaged.

Together these institutional factors have contributed to an important but largely overlooked shift in executive compensation strategy in the financial services industry. The most talented financial minds

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[2] See Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests*, July 10, 2007, at 50.

among us are increasingly leaving investment banks and other corporate employers to start or join private investment funds organized as partnerships.

The scholarly viewpoint. The third and final point is to underscore the widespread agreement among academics and economists that the status quo is untenable as a matter of tax policy.

As academics, we are privileged to have the opportunity to reflect on broader policy issues, to research and track the evolution of the law over time, and to make reasoned judgments with some distance from the politics of the day. The Senate Finance Committee has already heard from Professors Mark Gergen (University of Texas), Joseph Bankman (Stanford), Charles Kingson (University of Pennsylvania), and Darryl Jones (Stetson). Numerous other academics that I have spoken with agree that there is a powerful case for reform, including Lily Batchelder (NYU), Dan Shaviro (NYU), Noel Cunningham (NYU), Alan Auerbach (Berkeley), John Colombo (Illinois), and Richard Kaplan (Illinois).

To be clear, not everyone agrees on exactly what we ought to do about the problem. Some academics believe the only way to solve this problem would be to eliminate the capital gains preference altogether.[3] I disagree with that view. Professor Michael Knoll (University of Pennsylvania) and others are justifiably concerned that the revenue generated by the bill might be limited by creative workarounds.[4] A few professors have been retained by the private equity industry to argue for the status quo; there may be a handful of others who independently support the status quo, but they are few and far between. Our treatment of carried interest is simply inconsistent with other broad principles of tax policy, like having a progressive rate structure and taxing compensation as ordinary income.

The fact that there may be additional opportunities for gamesmanship in response to the proposed bill is not, to my mind, a reason

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[3] Cf. Chris Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What is it? Why is it Bad?*, 2007 working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=996665.

[4] See Michael Knoll, *The Taxation of Private Equity Carried Interest: Estimating the Revenue Effects of Taxing Profits Interests as Ordinary Income*, 2007 working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1007771.

for inaction now. Some of the workarounds, like paying carried interest on a deal-by-deal basis, change the fundamental economic contract between the fund managers and the investors in a way that investors may not put up with. Other workarounds may not actually "work" under current law. The point is that these details can be ironed out, and we should not let the private equity industry's threat of further gamesmanship justify inequities and inefficiencies in the current law.

Contact Information

Victor Fleischer
Associate Professor
University of Illinois College of Law
504 E. Pennsylvania Ave.
Champaign, IL 61820
(217) 333-1286

victor.fleischer@gmail.com

Mr. LEVIN OF MICHIGAN. Thank you very much.

Professor Gergen.

STATEMENT OF MARK P. GERGEN, PROFESSOR OF LAW, THE UNIVERSITY OF TEXAS SCHOOL OF LAW, VISITING PROFESSOR, HARVARD LAW SCHOOL

Mr. GERGEN. Thank you for inviting me. I am going to abbreviate my remarks because I think there is no serious policy or fairness argument against a taxing distributive share that is compensation as compensation.

All the policy and fairness arguments you hear are rhetoric or special interest pleading.

There is one serious argument against it, and that is what I want to talk about. That is that the change is going to increase complexity without raising revenue.

We all want a tax system that is workable. What I want to tell you is that argument, while it is a serious argument, is finally not a good reason to reject this change.

First, H.R. 2834 will simplify tax law on one important dimension. It will clarify the relationship between partnership tax and the rules in section 83 on the taxation of receipt of property for services.

In one direction, it is simplification. This now is a problem for tax lawyers and it is a problem for the Treasury, which is trying to figure out how these two different rules fit together.

Second, many of the technical problems that are raised by H.R. 2834 are easily dealt with in existing Subchapter K. I talk about this in my prepared statement. I will not repeat it here. We have rules in section 704 and section 737 that make sure we tax compensation when a partner liquidates their interest or when the interest is sold.

Subchapter K is there to make the solution work. Complexity is increased only on one dimension. There is one new issue that H.R. 2834 raises, and that is identifying the part of the distributive share that is compensation. That is a new issue. The law is going to be more complex on that dimension.

For many partnerships where partners contribute equal capital and take equal distributions or where they all contribute equal labor, it is not going to be an issue. The issue does not arise. It only arises in those partnerships where some contribute capital and some contribute labor.

In those partnerships, they know the deal they are negotiating. I contributed capital. You contributed labor. You are going to get a smaller return, or part of your return is going to be for labor.

The argument that the bill will not be effective, that it will not raise revenue, is that there are various things people in the industry can do to avoid having their income characterized as a return on labor, to treat it as a return on capital.

Victor Fleischer has talked about one of them. They will make an interest free non-recourse loan to create a capital account.

Another possibility in the venture capital context is they will say I actually contributed capital in the form of a zero basis intangible called goodwill. A third is they might try to say that some of this carried interest is really return on whatever my capital contribu-

tion was in return for bearing greater risk or taking a deferred return.

I talk about these matters in my paper. Two points we can take away from it, you will get some income. You will identify some of this as compensation, not all of it. You are not going to be over taxing the return to labor. At the end of the day, whatever you are going to do, you are going to be under taxing the return to labor because of these various possible evasions.

Finally, these are the sort of issues we deal with on a daily basis in the income tax. Most of these can be dealt with in a very general way in the statute and then you turn it over to the Treasury.

I think this bill is a no brainer. Finally, I would fix H.R. 2834 by expanding it. You are attracting a lot of criticism because you are targeting investment services. You should not limit this to investment services. It should apply to any partnership where somebody is contributing labor and in return getting a return from somebody else's capital.

Thank you.

[The prepared statement of Mr. Gergen follows:]

Prepared Statement of Mark P. Gergen, Professor of Law, The University of Texas School of Law, Austin, Texas

How to Tax Carried Interests

Mark P. Gergen*

There is a fairly simple solution to the problem of the taxation of carried interests: amend Section 702(b) to treat a partner's distributive share as ordinary income when the partner receives the distributive share as compensation for services rendered by the partner to the partnership.[1] The capital accounts system, which is the core of modern Subchapter K, makes it possible to identify compensation. This change would also solve some other substantive and technical problems under current law.

The Carried Interest Problem

Managers of private equity funds typically are compensated for their services by being paid a base fee of 2 percent of the fund's assets plus 20 percent of the fund's profits after investors receive a specified return. The 2 percent is ordinary income to the manager and an expense to the fund. The 20 percent is taxed as if it was an investment return. If the profits are in the form of capital gains, then this part of the manager's compensation is taxed at the capital gains rate (15 percent) and not at the ordinary rate (35 percent or more with phase outs). If it is interest income, then the manager avoids the self-employment tax (the 2.9 percent Medicare or Hospital Insurance tax has no ceiling). If it is tax exempt income, then the compensation is tax free. The unfairness of this is evident.[2] It may also be inefficient as it may distort contract design and resource allocation.

Current Law

The question of how to tax a partner who receives a profits share as compensation for services is an old one. It has long been settled that a partner who receives a

[1] Section 1402 also should be amended to make this income subject to the self-employment tax.

[2] David Weisbach, The Taxation of Carried Interests in Private Equity Partnerships, 2007 TNT 122–77 (July 30, 2007), argues to the contrary that similarly situated taxpayers who profit from managing their own money are treated as having capital gains. Of course, fund managers are different because they profit from managing other people's money. Weisbach elides this important difference by analogizing to the case where a taxpayer profits from intelligently managing investments made with borrowed money. It is an inapt analogy. A taxpayer who invests borrowed money would have to pay interest (putting to the side investments made on a margin account). Investors in a fund have a preferred return, they do not have a guaranteed return. There is little economic difference between a carried interest and an alternative structure where investors fund a manager's capital account with a nonrecourse loan. I will come back to this point. But there is an important tax difference. If adequate interest is not charged on the loan, or if charged interest is foregone when a manager's share of a fund's profits is insufficient to pay the interest, then interest will be imputed as ordinary income under § 7872.

capital interest in a partnership as compensation has ordinary income, generally when the interest no longer is subject to forfeiture. Regulations proposed in 2005 would settle two open questions.[3] One question regards the measure of income. The choices are between the market value of the interest (what a buyer would pay for the interest in an arms-length transaction) and the liquidation value of the interest (what the partner would receive if the partnership sold all of its assets for their fair market value, repaid its debts, and then liquidated). The market value of an interest may be lower than the liquidation value because of such factors as illiquidity or a minority discount. The other question regards the treatment of other partners. In particular, if the partnership has appreciated assets, then do the other partners recognize gain on the exchange of the interest for services, as they would have recognized gain had they exchanged the underlying assets for the services? The proposed regulations provide the service partner is taxed on the liquidation value (assuming an election is made) and that other partners do not recognize gain or loss on the underlying assets.

Debates over how to tax a partner who receives a profits interest for services generally have focused on the possibility of taxing the service partner on receipt of the interest. Two cases that are staples of the partnership tax course, *Diamond*[4] and *Campbell*,[5] hold that a service partner has income on receipt of a profits interest. In the odd circumstances of *Diamond* (and maybe of *Campbell*), the result made sense. But there is little support for generalizing the rule. It is not in Treasury's interest to try to tax profits interests on receipt for several reasons. The value of an interest often will be speculative, taxpayers have an informational advantage, and the government always loses at the margin on valuation as only a substantial undervaluation is likely to attract challenge and a penalty. Also an interest can be structured in ways that minimize its value on receipt. The experience with family limited partnerships is instructive in all of these regards. Further, typically a partner's right to profits will be contingent on the partner performing services during the period the profits are earned. The risk of forfeiture gives a partner the right to elect whether to be taxed on receipt. This election combined with valuation problems invites strategic behavior.

Treasury responded to *Campbell* in 1993 with a ruling that a partner was not taxed on receipt of a profits interest for services, except in three limited situations not relevant here.[6] The 2005 proposed regulations maintain this position while integrating it with Section 83, which generally governs the taxation of compensatory transfers of property. Under the proposed regulations, to avoid tax on grant of a profits interest, the partnership agreement must provide for something called a "safe harbor election."[7] On the election the interest is valued based on its liquidation value at the time of grant, which is zero in the case of a profits interest. In addition, if the profits interest is subject to a substantial risk of forfeiture, which typically is the case, the service partner must make a Section 83(b) election so that the profits are not taxed as compensation when the right to them vests.

This is not a happy resolution of the matter for reasons independent of the problem of carried interests. It is not clear what tax consequences follow if people do not make the elections. If general Section 83 principles apply, then a service partner would have ordinary income equal to the market value of a right to partnership profits when her right to those profits is no longer subject to a substantial risk of forfeiture. The other partners would include the service partner's share of profits in their income and get a deduction equal to the amount of the service partner's income when her right to the profits vests. This may temporarily shift income from the service partner to the other partners if her right to the profits vests in the year after they are earned. And, if the right to profits is valued at either a discount or

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[3] See Notice 2005–43, 2005–24 IRB 1221.

[4] Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974).

[5] Campbell v. Commissioner, T.C. Memo 1990–162, reversed 943 F.2d 815 (8th Cir. 1991). The government conceded on appeal that the tax court erred in holding a service partner had taxable income on receipt of profits interest. The Court of Appeals side-stepped the issue (while questioning the tax court's decision on the point) by holding Campbell's interest was of speculative value.

[6] Rev. Proc. 93–27, 1993–2 C.B. 343. The exceptions were (1) an interest in a substantially certain and predictable stream of income; (2) the partner sells the interest within two years; and (3) a limited partnership interest in a publicly traded partnership. Under the proposed regulations, the safe harbor election is not available in these situations. Rev. Proc. 2001–43, 2001–2 C.B. 19, clarified that when a partner was granted a nonvested profits interest he would be treated as receiving the interest on the date of grant so long as he was treated as a partner from that date.

[7] As an alternative to making the election in the partnership agreement the partners may make the election individually so long as all do so. A global election is required to prevent partners taking inconsistent positions.

a premium, this creates offsetting built-in gains and losses between the service partners and the other partners.[8] While it is hoped that taxpayers will make the required elections to avoid these problems, it is odd to require taxpayers to make two elections to avoid a trap.

The proposed regulations also leave the carried interest problem uncorrected. Treasury is not to be faulted for it does not have the statutory tools to solve the problem.[9] But a solution is available within the general framework of Subchapter K.

The Solution Available in the Capital Accounts System

Congress could take an important step towards solving the problem of carried interests by amending Section 702(b) to provide that a partner's distributive share shall be treated as ordinary income when it is compensation for services rendered by the partner to the partnership. Section 1402 also should be amended to make this income subject to the self-employment tax.

This is only a partial solution for it creates subsidiary problems. The capital accounts system in Subchapter K helps to solve these problems. Under current law, the capital account measures the value of assets contributed by a partner to a partnership, plus the partner's distributive share of income, minus the partner's distributive share of losses, and minus the value of distributions to the partner. In addition, when there is a non pro rata contribution or distribution from a partnership, assets generally are booked up or down to their fair market value and partners' capital accounts are adjusted accordingly. The capital account system is a linchpin of the rules on special allocations, built-in gain or loss, basis adjustments, and more. It is the conceptual framework of modern Subchapter K.[10]

The capital account makes it possible to identify when a distributive share is compensation. A simple rule would characterize a distributive share as compensation if the partner performs services for the partnership to the extent the distributive share is in excess of the partner's pro rata share in partnership capital. There are more fine-grained ways to identify compensation that would enable partners who contribute both capital and labor to take a preferred return on capital without having it characterized as compensation.[11] The capital account system also supplies a mechanism for handling the sale or liquidation of an interest by a service partner when the interest bears unrealized profits that would have been taxed as compensation to the service partner when realized. The solution is to treat the partner as having compensation equal to the amount of compensation the partner would have had if the partnership had sold its assets for their fair market value immediately prior to the sale or liquidation. The handling of a sale follows Section 751(a). The handling of a liquidating distribution follows Section 737. The Section 704(c) regulations preserve the attribute of booked built-in gain as compensation through various events in the life-cycle of a partnership.

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[8] Consider an example. Assume A manages assets worth $1 million and the partnership earns $100,000 in year one. Her share of profits is $20,000. Assume that her right to these profits is worth only $15,000 (this could well be the case if the profits are undistributed, A does not have the power to compel a distribution, and the interest is illiquid). Under general Section 83 principles, A would have $15,000 ordinary income and the other partners would have $85,000 income (their share of profits, plus A's share, minus an expense equal to A's income). Comparing the basis of the interest and the capital account, A would have a $5,000 built-in gain and the other partners a $5,000 built-in loss. If A's right to the profits vested in a year after they were earned, then the other partners would have $20,000 income on profits that probably would ultimately go to A and an offsetting deduction of $15,000 when A's rights to the profits vests.

[9] Section 707(a)(2)(A) is not a reliable tool. It empowers Treasury to issue regulations to recharacterize allocations and distributions to a partner for the performance as services as a transaction with a nonpartner if they are properly so characterized. This rule is alongside and was enacted with the rules on disguised sales in 1984. The concern was that a partnership might avoid capitalizing an expense by giving a service provider a temporary, low-risk interest in partnership income. To solve the problem of carried interests using Section 707(a)(2)(A) Treasury would have to take the position that a fund manager was not truly a partner. This is untenable unless one is willing to take the position that to be a partner in a capital-based partnership a person must contribute and risk capital. See Mark P. Gergen, Reforming Subchapter K: Compensating Service Partners, 48 Tax L. Rev. 69, 75–81 (1992).

[10] I discuss the evolution of the system in Mark P. Gergen, The End of the Revolution in Partnership Tax?, 56 S.M.U.L.Rev. 343 (2003). Later I discovered that the principal creator of Subchapter K proposed a similar system to deal with precontribution gain and loss and related problems. See Mark P. Gergen, The Story of Subchapter K: Mark H. Johnson's Quest, Business Tax Stories 207 (Foundation 2005).

[11] Any such rule should cap the amount of the preferred return and require that the yield on the service partner's capital account, including the preference, not be greater than the yield on other capital.

Different approaches are possible under the capital accounts system in the case of an asset revaluation. Assume A performs management services in a partnership with $1,000,000 assets in return for 20 percent of the profits. The assets grow in value to $1,500,000, which is unrealized appreciation. At this point $500,000 new capital is contributed to the partnership. Under current law, the partnership may elect to book up its assets and give A a capital account of $100,000.[12] At some point A should have $100,000 income treated as compensation. One possibility is to recognize the income at the time of the revaluation. But this creates a troubling disincentive for non pro rata contributions and distributions, which generally trigger revaluations. Managers would become loathe to permit non pro rata contributions and distributions if it triggered a substantial tax liability to them. Another possibility is to tag A with that much built-in gain on the assets, which will be treated as compensation when A liquidates or sells the interest. It is a mistake to push recognition past when A receives a liquidating distribution for this would permit A to take property as compensation without paying tax. This violates Section 83.

At a deeper level, the capital accounts system is consistent in principle with recharacterizing a fund manager's share of capital gains as compensation. The capital accounts system embraces the aggregate theory of partnership tax. The carried interest problem exists because Section 702(b) follows the entity theory—the character of income is determined at the partnership level. From the perspective of the fund income is a return to capital. From the perspective of the manager it is compensation.

Distinguishing "Sweat Equity" and the Issue of Scope

Capital gains earned by a fund manager or a venture capitalist have been likened to the capital gains realized by a sole proprietor or a partner who builds up a business, such as a veterinary clinic or a bagel shop, and then sells it. An entrepreneur, such as the vet or the bagel store owner, will have capital gain on sale of the business on amounts paid for good will or going concern value. Capital gains earned by a fund manager or a venture capitalist are quite different from an entrepreneur's sweat equity. The entrepreneur will earn ordinary income in creating good will. In addition, the entrepreneur can convert good will into capital gain only by selling the business and, typically, structuring the sale to allocate price to good will, which often diminishes the tax benefits to the purchaser.

The simple solution I propose would change the treatment of good will in a business where partners made unequal capital contributions. For example, if A and B went into a partnership to open a bagel shop, with A contributing capital and B labor, B's gain on the sale of the shop would be ordinary income. The current treatment of good will can be preserved by excepting from the definition of compensation capital gain attributable to good will on sale of a business or liquidation or sale of a service partner's interest.

This raises the larger question of the appropriate scope of a rule characterizing as ordinary income a partner's distributive share of income that the partner earned by performing services for the partnership. The Levin bill comes at this question from one direction, characterizing as ordinary income a partner's distributive share only insofar as the interest is received for the performance of investment management services. Under the Levin bill, a partner who provides services in return for an interest in a real estate development project or in an oil and gas venture might not have his distributive share recharacterized as ordinary income. I say might because the definition of investment services could cover some service partners in real estate and oil and gas partnerships. This points up two problems with the approach taken in the Levin bill. "Investment services" is an amorphous category that has uncertain application outside the targeted case of an investment fund manager. Another objection is that it is difficult to justify treating a fund manager differently than a partner who receives an interest for contributing managerial or operational services to a real estate development project or an oil and gas venture.

The approach I propose comes at the question from the other direction, characterizing as compensation any part of a distributive share received by a partner who performs services for a partnership that is in excess of the partner's pro rata share of partnership capital. This gives rise to a different type of problem. It makes it necessary to carve out exceptions for cases where it is thought inappropriate to characterize a distributive share of capital gains as compensation. For example, an exception probably should be made for capital gain attributable to the sale of patent rights and similar intellectual property. This preserves consistency in tax treatment

[12] Some think this is required. Such adjustments are standard in partnership agreements, which often are drafted to track tax law rules.

with the case of an individual who sells such property created by her personal efforts.[13]

Is the Game Worth the Candle?

Under the Levin bill (and the approach I propose) fund managers may use various strategies to avoid having their distributive share of profits characterized as compensation. These include: 1) Make a capital contribution with funds provided by the investors through an interest-free nonrecourse loan secured by the manager's partnership interest. 2) Take the position that the manager makes a capital contribution in the form of intangibles. 3) Take the position that the carried interest is a return on capital contributed by the manager.

The nonrecourse loan strategy should be permitted. Existing law generally treats a nonrecourse loan as equivalent to a cash investment though it is well-known that a nonrecourse loan is unlike a cash investment or a recourse loan because the lender, and not the taxpayer, bears the risk of loss on the investment securing the loan. Standing alone this strategy leaves a fund manager with compensation equal to the imputation rate under Section 7872. There is an argument that this approximates the theoretically correct amount of compensation.[14] The gist of the argument is that returns in excess of (or lower than) the risk-free return on the share of capital committed to a manager in return for services are returns to risk-taking and not returns to labor.

The other two strategies are more problematic, particularly if they are combined with the nonrecourse loan strategy. It would be difficult for the government to challenge an arrangement where cash investors agreed to credit a fund manager with having contributed intangibles, such as good will. While the intangibles would have a zero basis their assigned value would be credited to the manager's capital account. Under the Levin bill (and the approach I propose) that fraction of the manager's distributive share would not be characterized as compensation.[15]

Insofar as the law recognizes that returns to capital may be non pro rata when differential allocations are made to suit partners risk and time preferences, the possibility exists for managers to characterize what in truth is a return to labor as a return to capital. A concrete example is useful. Assume manager ("M") contributes 5 percent of the capital to a venture and limited partners ("LPs") contribute 95 percent. Profits (net of M's guaranteed compensation) are allocated first to the LPs until they receive an 8 percent return. Thereafter profits are allocated 20 percent to M and 80 percent to the LPs. M will take the position that more than one-quarter of its 20 percent share of profits is a return on its investment of 5 percent of partnership capital because part of the premium is compensating it for bearing greater risk of return on its 5 percent. How aggressive M can be in characterizing the 20 as a return to capital depends on the rule policing such matters. One could imagine a rule of thumb developing that permits a return to be treated as a return to capital up to a stipulated multiple of a partner's relative capital account balance, such as 140 percent.[16] This rule of thumb would allow M to treat 7 of its 20 percent as a return to capital. M could increase the amount of its 20 percent return that is treated as a return to capital by using the nonrecourse loan and intangible contribution strategies to increase its capital account. Assuming a 140 percent rule of thumb, for example, M could treat its entire 20 percent as a return to capital by ginning up a capital account totalling slightly more than 14.3 of partnership capital with a combination of real capital, intangibles, and a nonrecourse loan. M's compensation would be the interest imputed on that fraction of the capital account funded with the interest-free nonrecourse loan.

This simple illustration suggests that claims that the Levin bill (or the approach I propose) create complexity without changing results are overblown. Some fraction of a fund manager's 20 percent share will be taxed as compensation. The size of the

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[13] The rule in § 1221(a)(3) excluding from the definition of capital assets property created by a taxpayer's personal efforts applies only to "a copyright, a literary, musical or artistic composition, a letter or memorandum, or similar property. . . ." This has been held not to cover patent rights and trade secrets. The reason for the different treatment is not clear.

[14] See Two and Twenty: Taxing Partnership Profits in Private Equity Funds, forthcoming NYU L. Rev (2008). The paper is available on SSRN.

[15] Under § 704(c), a manager might be allocated ordinary income equal to annual depreciation of the good will as this is the amount book depreciation of the good will would exceed tax depreciation. However, this would happen only if the partnership elected a method other than the traditional method or if the partnership was required to use the remedial allocation method under the anti-abuse rule. If a partnership was required to use the remedial allocation method, then the manager would have ordinary income and the other partners an ordinary deduction, which would reduce the advantage to the managers of characterizing part of their contribution as intangible assets.

[16] I use this number for illustrative purposes.

fraction depends on details, in particular the rule delimiting what will be treated as a return to capital, and on how people respond to the change. Measures can be taken to increase this fraction. For example, a capital contribution funded with an interest-free nonrecourse loan may be allowed to be treated as bearing a return no greater than the imputation return. And the government could announce a policy of scrutinizing contributions of zero-basis intangibles. Such measures add complexity but it should be manageable.

Side Benefits

The proposed change solves some other problems. It makes it possible to exclude profits interests from Section 83. The receipt of a right to profits need not be treated as a receipt of property to be taxed as compensation when the profits themselves will be taxed as compensation when they are earned. This eliminates the need under the proposed regulations to make one or two elections and avoids the problems that arise in the absence of an election. Remaining is the question of how to handle the case where retained profits are subject to a substantial risk of forfeiture. Consistent with Section 83, the partner could make a Section 83(b) election and be taxed on the distributive share[17] or the partner could forego the election and wait and be taxed on the value of the profits accumulated in her capital account when the interest vests. If the election is not made, then the distributive share would be taxed to the other partners, who would get an off-setting expense when the service partner takes the profits into income, bringing the other partner's tax position and capital accounts into line. This leaves some differences between the taxation of a compensatory grant of a profits interest and the taxation of a compensatory grant of an option, which can be economic equivalents. This is a more general problem that results from the reluctance to treat an option holder as a partner until the option is exercised. The option arrangement enables the service partner (or any other option holder) to defer recognition of income on its distributive share until the option is exercised.

The proposed changes foreclose some other troublesome possibilities under current law. In the 1980s I heard rumors of a film deal where an actor took a profits interest. The plan was that the partnership producing the film would buy property to be used in the production. When the film was done, the actor received the property in liquidation of his interest without paying tax. Current law on profits interests allows people to evade the rules on equity compensation. For example, if an employee is given a stock appreciation right, then he will have ordinary income on the amount of any appreciation. Instead put a block of the same stock in a partnership and give the employee a profits interest in its appreciation. After the stock appreciates, distribute to the employee stock equal in value to her share of the appreciation. The employee will be taxed on only part of the gain under Section 731(c) and it will be capital gain. Under the rules I propose the actor and the employee would have taxable compensation on the distribution.

Some of the problems addressed by Section 707(a)(2)(A) would not be solved. Section 707(a)(2)(A) is primarily directed as cases such as where an established partnership that develops and holds real estate gives an architect a short term interest in its rental income in return for services designing a new building. This allows the partnership to get a result equivalent to a short-term write off of the architect's fee and to avoid capitalizing the expense. Changing Section 702(b) would treat the rent as compensation to the architect. But it would not require the partnership to treat it as an expense and to include the architect's share of rents as income to the other partners.[18]

* Fondren Chair for Faculty Excellence, University of Texas School of Law. This significantly revises and supplements testimony I presented to Senate Finance Committee in July 2007.

Mr. LEVIN OF MICHIGAN. Thank you very much.

Under the rules that were used for the last panel and Mr. McCrery has agreed that we will follow them, we will do this.

[17] In the event the interest is forfeited, it is necessary to use either a deemed guaranteed payment or a side-agreement requiring the partner to forfeit his partnership interests to the other partners. From the perspective of the service partner, the deemed guaranteed payment is preferable because it provides an ordinary deduction to offset the ordinary income.

[18] A partnership would have the ability to treat the compensation as an expense by actually paying profits-based compensation or by making a guaranteed payment. If the profits are to be retained within the partnership, then the service partner would recontribute the payments.

Those who did not ask questions the last time, the last panel, will go first. In view of the hour, we will limit our back and forth to 3 minutes. I think that is only fair. We have another panel to go.

First, following that rule, will be Mr. Tanner. You are first.

Mr. TANNER. Thank you, Mr. Chairman. I like this rule.

[Laughter.]

I have just one question. I want to thank all of you for your participation and for your most provocative comments.

Mr. Orszag, I read your testimony last night before Senate Finance and then today's, and I am intrigued by the implicit loan perspective. May I ask if you would elaborate on that for the panel and how you would treat the non-recourse loan basically as ordinary income and so on?

Mr. ORSZAG. Sure. I would note that since Professor Fleischer is on the panel, this idea has been discussed in some of his work. Let me just describe it briefly.

Mr. TANNER. Yes, whoever.

Mr. ORSZAG. I can do it.

Very quickly, providing a 20 percent carried interest is equivalent to providing a non-recourse loan from some perspectives, equivalent to 20 percent of the fund's capital. So one could at least view the carried interest as equivalent to that implicit loan, for example, with no hurdle rate, a zero interest rate, on that implicit loan.

The tax treatment that would follow from that would tax at the bond rate of return or the Treasury rate of return, the interest on that implicit loan as ordinary income, and anything above that as capital income.

That is one of the perspectives that would lead to a kind of mixed outcome, somewhere between ordinary income and the current treatment for capital gains generated income.

I would note, however, that implementation could become quite complicated.

Mr. LEVIN OF MICHIGAN. Mr. Fleischer.

Mr. FLEISCHER. I would just add there is an easier way to think about this implicit loan concept. Instead of getting all capital gain on the back end, the fund managers take some ordinary income up front as the income accrues and then get capital gains on the back end.

This is a lot like taking cash salary every year. If the fund managers just took cash salary and then re-invested in their own funds, we would give them—if they pay tax on the cash salary, they are going to get capital gains treatment on the back end, just like any other investment. Nobody has been talking about trying to do away with the capital gains preference generally. If you actually make a real investment, you get capital gains treatment on the back end.

The implicit loan concept is just taking a portion and taxing it, ordinary income, like an accrual method, and then giving capital gains on the back end.

I think this reaches a reasonable policy result.

Mr. LEVIN OF MICHIGAN. Go ahead.

Mr. TANNER. Just one follow up. In practicality, you mentioned maybe the complexity of enforcement and so forth. Could you give us some idea of what you mean by that observation?

Mr. ORSZAG. Sure. For example, I mentioned that the implicit interest rate would be presumably, at the Treasury bond interest rate. There is a broader set of questions about whether risk should be taken into account because obviously that loan, basically that transaction, has different characteristics than a Treasury bond.

Changing that with regard to this particular example would then raise lots of questions for the broader set of loan subsidies and their treatment in the Tax Code. There also are issues that could potentially arise with regard to loan forgiveness and other things.

The point is there is not an actual loan being made, so the construct is useful analytically, but implementing it as an actual tax procedure could become quite difficult quickly.

Mr. LEVIN OF MICHIGAN. Mr. Camp.

Mr. CAMP. Thank you. Mr. Levin, there is legislation that would subject holders of carried interest to ordinary income tax treatment, and if carried interest is taxed at that level, should there not also be an offsetting deduction to the capital investors to account for their payment of compensation to the managers?

If it is income, should there not be a countervailing business deduction?

Mr. LEVIN. Yes, under any rational system of taxation if you were to view the fund as paying compensation to the general partners, then the limited partners should get an equal and offsetting deduction, but the bill that is pending now does not call for that.

Mr. CAMP. Does not do that. Therefore, the score, as everyone around here looks for money, the score on the bill would be much less because the offsetting deduction was not taken into account in the scoring of the bill.

Is there any other place in the Tax Code that income is characterized based on the identity of the recipient as opposed to the source of the income?

Mr. LEVIN. There is no comparable place in the Internal Revenue Code where gain from the ultimate sale of a capital asset held for more than 12 months is transmuted into ordinary income.

As other witnesses have said, we have a partnership system of taxation utilizing a flow through approach. Where a partnership recognizes a long term capital gain on an asset, that gain flows through to all the equity owners as capital gain under our existing system. That is designed to encourage people to invest in entrepreneurial businesses and to help American business and employment grow.

The same set of rules should apply to a person investing in stocks and real estate, as I talked about in my testimony, even if that person devotes serious labor every day, 8 hours a day, studying what stocks and real estate to buy and sell, so he or she is taxed as capital gain when the stocks and real estate are sold, because he or she has purchased a capital asset and held it more than 12 months. I do not see a reasoned distinction when you turn instead to an entrepreneur, such as Bill Gates, who starts a business along with investors, and Mr. Gates has a higher percentage of the common stock than his capital would have purchased. His gain at the sale of the company should be taxed as capital gain.

Then we move to a third example, which is a private equity fund, and perhaps the private equity general partners put in, e.g., 10

percent of the capital, but perhaps get 20 or some higher percentage of the gains. They are the principals. They are the owners. They make the buy and sell decisions. They act for themselves, not as agents. Therefore, if we were to take capital gain treatment away from private equity general partners because they produce sweat, whether we should take it away from Mr. Gates when he starts the computer company and works at it for 10 years before selling at a capital gain or from Mr. Buffett who buys stocks and real estate and works at it 8 hours a day for several years.

Until now, our Internal Revenue Code has made the test whether you are an owner or part owner of a capital asset held for more than 12 months. The Code has not asked us to get into subjective issues like is there any sweat involved.

Nor have we had a law that differentiated between industries, designating the investment advisory industry or the real estate industry as tainted, so that carried interest from those, in capital gain generated by those tainted industries is taxed as ordinary income, but the oil and gas industry or manufacturing or distribution are not tainted industries.

This approach takes an otherwise over complicated Internal Revenue Code, badly over complicated, and makes it even more complicated. While people talk about this bill as if it were simple and just said capital gain becomes ordinary income if you have a carried interest in capital gain generates by certain industries in reality, this bill is ten pages long, adds another ten pages to the Internal Revenue Code.

Every time we do that with special legislation, singling out industries, singling out taxpayers, seeking to designate sweat as a tainting factor, we make the Internal Revenue Code more complex and less administratable.

Mr. LEVIN OF MICHIGAN. Thank you.

Mr. CAMP. Thank you, Mr. Chairman.

Mr. LEVIN OF MICHIGAN. Mr. Larson.

Mr. LARSON. Thank you, Mr. Chairman. I am working up a big sweat over here. There is a lot of sweating going on.

I saw Mr. Orszag's consternation as Mr. Levin was answering this. I would like to ask him if he would like to rebut Mr. Levin's response.

Mr. ORSZAG. I am not in the business of rebutting, but let me offer some comments on the sweat equity issue.

I actually think the Joint Committee on Taxation's document that was prepared for this hearing treats this issue quite well and in some detail on pages 57 and 58.

CBO's testimony has a box on sweat equity. As the Joint Committee notes, the better analogy to the sweat equity for Mr. Gates may be what happens to the management fund itself, the general manager, that is, when the general manager or the fund in particular goes public.

I do not think anyone would argue that a capital appreciation on that fund, which is typically organized as a partnership, as opposed to the investment fund itself, that should not be given capital gains treatment under current law.

That is not really what is at question. The question is what should happen to the flow of income to the general partner in the

intervening period while you are sort of building up that capital asset, which is then sold when the management fund goes public.

That is a different question.

Mr. LARSON. Reclaiming my time on the question——

Mr. ORSZAG. Sure, I'm sorry.

Mr. LARSON. One of the common criticisms we have heard about the Levin bill is that essentially what this is going to do is drive hedge fund managers offshore, as we heard this morning in testimony, that is already going on.

If the Levin bill were to become law, would there be a mad rush for these firms to go offshore, in your opinion?

Mr. ORSZAG. There may be some pressure. Again, I would note that the general managers themselves, ultimately you have to tie this back to an individual. U.S. individuals are generally taxed on their worldwide income regardless of where they reside, and therefore, it is very difficult to escape U.S. taxation.

The fact that there is so much activity abroad already suggests—I will leave it at that. The written testimony discusses this.

Mr. LARSON. Mr. Levin, just a quick question for you, is there a policy or public policy reason why hedge funds and private equity managers should be treated differently than those in any of the big investment firms, outside of the sweat?

Mr. LEVIN OF MICHIGAN. If you would answer quickly because the 3 minutes are up and Mr. McCrery has to leave and wanted to ask a few questions.

Mr. LEVIN. The answer is there is. In this country, we have two systems of taxation, the corporate system of taxation, under which employees of a corporation who receive compensation from that corporation are taxed as ordinary income.

We have a second system which is a partnership or flow through system under which you look at the nature of the income recognized by the entity, the partnership.

In those years when the partnership is operating a business and earning $100 of ordinary income, when that flows out, either as carried interest or capital interest, to the partners, it is taxed as ordinary income.

So many people have erroneously stated that carried interest is taxed as capital gain. It is not. Carried interest in ordinary income is taxed to them as ordinary income.

When the partnership ultimately sells the business and recognizes a long term capital gain, gain from an asset held for more than 12 months, and that capital gain flows out under our partnership system, which was adopted in order to encourage people to put labor, capital, know-how and goodwill together and build businesses, under that system, when the capital gain ultimately is recognized, it flows out as capital gain, it retains its character.

There is a thus a profound difference between the corporate system and the partnership system. If this Committee would like to reform the Code and adopt one integrated system, not a corporate system, not a partnership system, but one system, that would simplify the Code.

I so testified in front of the President's Tax Reform Panel 2 years ago, that it was desirable to go to one integrated tax system. That is not going to happen now.

Mr. LEVIN OF MICHIGAN. Thank you, sir. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

One example that you did not use, Mr. Levin, is something that happens all the time in my hometown of Shreveport. You have two guys that get together, maybe two brothers. One of them might be a banker. The other one is a carpenter. They get together and buy a house. The banker gets the money. He provides the money, buys the house. His brother gets in there and rehab's the house, and then 18 months later, they sell it. Is that a capital gain? Of course, it is.

Mr. LEVIN. What their enterprise realizes is a long term capital gain——

Mr. MCCRERY. It is a capital gain. Does the brother who got in there and did the work, does he pay ordinary income on that? No.

Mr. LEVIN. If this bill applied——

Mr. MCCRERY. No, current law.

Mr. LEVIN. Under current law?

Mr. MCCRERY. He does not pay ordinary income, does he? He pays——

Mr. LEVIN. Under current law, if the entity recognizes a capital gain——

Mr. MCCRERY. Because the capital asset was sold. You have two guys. One with money, one with sweat.

Mr. GERGEN. Mr. McCrery, that house is not a capital asset. It is like inventory. They are holding it to sell in the ordinary course of trade and business.

Mr. LEVIN. If this is the only house they bought, it would not be inventory.

Mr. GERGEN. If you were in the business of subdividing land and selling it off, that is treated as inventory and it is ordinary income. If you are in the business of developing houses and selling them, that is ordinary income, at the entity level as well as the individual level.

Mr. MCCRERY. You are telling me that if these guys buy a house and they hold it, they fix it up——

Mr. GERGEN. Not as an investment. They hold it to develop it, improve it and sell it, that should be an ordinary asset in their hands if they are complying with the rules distinguishing capital assets from ordinary assets.

Mr. LEVIN. If I may just disagree and qualify. If they buy one house and rehab it and sell it, that is clearly capital gain after 18 months. On the other hand, if they buy 100 houses, it becomes inventory to them because they are in a regular trade or business of selling rehabed houses.

I believe that the example we were given is two brothers buy a house. That would be capital gain.

Mr. MCCRERY. That is the example I gave. However, I will say in fairness, Mr. Gergen brings up an interesting point. I am still learning this stuff. That is something we should consider if these guys are in the business.

Another distinguishing factor, I think, with respect to private equity partnerships, in most arrangements, it is my understanding that there is a claw back provision in which if there is not a certain

level of gain realized for the investors, the partners do not get as much return; is that right?

Mr. LEVIN. That is correct.

Mr. MCCRERY. Is that not far different from just the examples that some have given of it is sweat equity so it ought to be ordinary income? That is risk, is it not?

Mr. LEVIN. It is risk.

Mr. MCCRERY. That is the whole point behind preferential treatment for capital gains, encouraging people with money to take a risk and invest that money in productive endeavors.

Thank you.

Mr. LEVIN OF MICHIGAN. My guess is we will get back to that when my turn comes. Thanks, Mr. McCrery. We will go back to our regular line here. We are asking people who did not have a chance last time, and then we will go back.

Mr. Kind, you are recognized for 3 minutes. We will try to stick to that, all of us, and also all of you. This is an important subject and I know it is hard to do that. Let's try.

Mr. Kind.

Mr. KIND. Thank you, Mr. Chairman. I want to thank the panelists for your testimony here today. It is important and it is somewhat complicated.

Let me try this. I am going to ask you each the same question. I am afraid it is going to require a longer perhaps complicated question. I think it is important to ask, in light of the carried interest issue that we are dealing with.

If we were to take the carried interest issue and treat it as ordinary income, can you think of any significant adverse economic consequences of us doing that, the impact it would have?

Do you want to take a shot at that, Mr. Gergen? We will go right down the line. If you think there is a more detailed answer that you need to have, maybe you can supplement your response a little later for the Committee.

Mr. GERGEN. I can think of no long term adverse economic impact.

Mr. FLEISCHER. I think the adverse consequences would be minimal, they would occur just at the margins.

Mr. KIND. Mr. Jones.

Mr. JONES. I would agree. I would add the investors are not just passive people. They are not going to just succumb to demand for higher salaries in order to make up for the tax.

Mr. STEUERLE. Generally, I am asked to think about these questions in a revenue neutral manner. I could take the revenues from this particular bill, apply it more equitably across capital income, especially to the highest taxed assets, and actually improve efficiency in the economy.

Mr. KIND. Thank you. Mr. Levin.

Mr. LEVIN. I do believe there would be adverse economic consequences in several respects. First of all, right now, we attract the best and the brightest, many of the best and the brightest in our society to private equity and venture capital and in making investments that better our economy, that create jobs.

Inevitably, when you reduce the take home pay for any job, you lose some of those best and brightest. There turns out to be another profession that is more attractive. That is the first thing.

The second thing is that inevitably, your best funds who have been content with 20 percent up until now, are going to say if it is going to be taxed more heavily, I would like to have 25 percent or 30 percent carried interest. You are going to get into negotiations between the general partners and the limited partners when you have this smaller pie to split up, that are going to be disquieting negotiations.

The better funds, some may get it. Some may not. You are going to inevitably in my view because of these two reasons reduce the efficacy of private equity and venture capital investing in our society.

Right now, we have venture capital and private equity driving our society to a more entrepreneurial job creating, prosperity creating society. I think it is the law of unintended consequences that if you are not careful and you do not know what you are achieving in terms of economics, you will find some surprises.

Mr. KIND. Thank you. Mr. Orszag.

Mr. ORSZAG. I think there may be some short term complexities that are created and some short term effects as people who did not anticipate the change when they first made arrangements for a particular fund to have to adjust to the fact that there are changes.

Over the longer term, I think most of the effect will be on the return that the general partners receive. I would suspect that most of the effect would be on that component.

I am somewhat skeptical that there would be very substantial effect on the labor supply of people into the private equity and hedge fund industry as a result. I think the biggest effect is likely to be on the after tax returns for the general partner, basically.

Mr. KIND. Thank you. Thank you, Mr. Chairman.

Mr. LEVIN OF MICHIGAN. Next, following our rules, Mr. Tiberi. We are doing those who did not question the last panel. We agreed on that.

Mr. Tiberi. You do not have to.

Mr. TIBERI. I will go ahead and yield my time back to you, Mr. Chairman.

Mr. LEVIN OF MICHIGAN. Ms. Schwartz.

Ms. SCHWARTZ. Thank you very much, Mr. Chairman.

I appreciated your comments on the last question. One of the other issues or one of the other concerns in terms of harmful effects if we make changes into the carried interest is on our public pension funds. This is a question for the next panel, but I thought I would ask your opinion about this as well.

With what some of the fund managers are saying, the public pension funds in particular, and as you know, as a state senator, I advanced the change in Pennsylvania to move from a legal list to a prudent person standard that ended up being hugely successful, lucrative for the Pennsylvania State Retirement System, which is great.

I fully support that. I think they have been responsible and it has reduced the amount of money that school districts in the state have had to pay into their state and teachers' retirement funds.

You said they are saying they are going to be hurt if we go ahead and make a change on this, that the fund managers will behave differently or they will not take on the pension funds or there will be an adverse consequence, or that they will somehow pass along the costs to those pension funds, and that the pensioners themselves will have to pay it somehow.

Could you speak to whether you in fact think that would be the effect and what has been successful would in fact be harmed by any change we might make in the carried interest?

I will ask which of you would like to take that on or if each of you would like to take that on, and again, I understand it has to be done briefly.

Mr. Fleischer.

Mr. FLEISCHER. Thanks. I think the concern is really overblown. Pension funds have a lot of different assets in their portfolio. I am not sure what the data is on Pennsylvania's fund. Typically, 5, 10, maybe as much as 50 percent in alternative assets.

We are only talking about a portion of the portfolio, and then we are talking about raising the tax rate only on the 20 percent upside that general partners take. We are talking about a subset of that portfolio.

Then you have to try to figure out if general partners can unilaterally raise their fees in response to the tax fee. It is pretty clear in a competitive market that they cannot do that.

Ms. SCHWARTZ. That has been the suggestion, that they would have to raise their fees and somehow that would be so significant to really have a broad impact. It is hard to imagine it would be that significant. That is really my question.

Mr. ORSZAG. Can I actually add on that? Over on the other side, the Senate Finance Committee also had a hearing on this. Professor Alan Auerbach from Berkeley answered this question directly. I am just going to quote to you from his written testimony.

"If half of the tax increase were shifted to investors," and I want to note I actually think that is too high, "the tax burden would imply a reduction of at most two basis points in the annual return on these pension funds' assets and quite possibly much less."

To translate that, that is instead of a return of 7.02 percent per year, that would be 7.00 percent per year. Again, he thinks it could be quite possibly much less.

Ms. SCHWARTZ. I do understand the pension funds initially wrote a letter saying it would be a problem and then took it back. California, in particular, the retirement fund there said they do not really see it as having much of an effect.

Mr. STEUERLE. Ms. Schwartz, just a couple of other quick comments. If we are worried about the impact on pension funds, there are also the managers of mutual funds, the managers of the pension funds themselves who pay ordinary tax rates.

We are encouraging those managers to move. If you are worried about incentives, we are encouraging those managers to move over and join the hedge funds instead.

You have a lot of these types of shifts. One can also worry about the taxes that are implicitly or explicitly paid by the pension funds. I again remind the Committee that we should be looking at the cor-

porate tax rate, which is where the tax on capital income is much higher than it is in the case of capital gains taxes.

Thus we are concerned about the taxes the pension funds pay or the amount of money they have to pay their managers, there are a lot more efficient ways to get at that issue than trying to worry about what tax might be paid by a very narrow set of managers within hedge funds.

Ms. SCHWARTZ. Mr. Jones, did you want to add to that?

Thank you very much. It is reassuring to hear that. Thank you, Mr. Chairman. I yield back.

Mr. LEVIN OF MICHIGAN. Following our rules, we will go this way. Mr. Cantor, you will go next. I will go last. Mr. Becerra, Mr. Doggett, Mr. Thompson, Mr. Emanuel, Mr. Blumenauer, and Mr. Pascrell. I will go at the end.

Mr. Cantor, you are next.

Mr. CANTOR. Thank you, Mr. Chairman. Mr. Chairman, again, I want to thank the panelists for your indulgence and being here.

I respectfully want to say first of all that some of the testimony given today in my opinion does not really reflect the true nature of an entrepreneur who may be operating out there today that wants to employ the partnership structure in order to invest in.

There has been a lot of discussion about private equity, about the richest Americans, about fund managers, about special interest rhetoric.

I think that the proposal that is on the table in the House at least, the Levin-Rangel bill, would have such a broad sweep to pull in the brothers that Mr. McCrery was talking about, assuming it was not their every day ordinary business, it was not characterized as inventory, and it was just an ownership interest in a partnership that was doing one house or that house.

To me, the nature of carried interest emanates from the need for partners, general and limited, to align their interests, and that when one takes a risk with his capital and is the money investor or the limited partner, that partner wants to have a general in there in the partnership with the same interest to see that deal, to see that investment through to the end with a similar interest.

Therefore, to me, I do not care how much investment or monetary investment, as Mr. Levin has said, you have sweat equity, you have a risk of your time that certainly has value, that may not pan out.

To me, it is the speculative nature of that capital that would qualify it or at least make it consistent with Congressional policy for decades, as was said earlier, that we want to prefer that investment because that is the way we can continue to see growth in our economy through entrepreneurial investment.

When we say—I think it was you, Mr. Jones, who may have said it is not fair to allow somebody making all this money to not pay taxes and to then tax the wage earner, I am looking at the mom and pop, the mom and pop partners that are out there. They are getting the same kind of treatment.

I do not know. Mr. Jones, if you want to take a stab at responding to me. I would like to hear some others as to the real nature of the interest we are talking about.

Mr. JONES. Every employer wants to align employees' interest to take into account the——

Mr. CANTOR. It is an ownership, and that is the difference.

Mr. JONES. Every incentive compensation scheme is designed to make the employees or the service providers' motivations more similar to the owner's motivation.

Mr. CANTOR. Is there not liability on the other side as well? If you have an employee, that employee is not at all liable in terms of being an owner the way a partner is.

Mr. JONES. Neither is the general partner in a venture capital fund. He is not liable for any losses.

Mr. LEVIN OF MICHIGAN. We are going to try to adhere to the 3 minute rule so we can get through this. If someone has to leave, we may ask indulgence that he or she go before.

Next is Mr. Becerra.

Mr. BECERRA. Thank you to all the witnesses for your testimony.

Let me pick up on the last series of questions and comments. Is there a case—and I would ask you to please be brief so I can try to get more than one question in—is there a case to be made that carried interest should be treated differently based on the type of investment or the industry involved?

We have been approached by folks who are publicly traded partnerships. We have had folks who are in real estate investment who have said there might be a difference between what a private equity firm does in that industry and what these other industries might do.

Is there a reason to consider treating an industry or a particular investment in those types of industries differently for purposes of carried interest?

Mr. GERGEN. Can I answer that?

Mr. BECERRA. Yes.

Mr. GERGEN. I think there are two, if you took my global——

Mr. BECERRA. If you do it briefly.

Mr. GERGEN. One is the genuine sweat equity. The people who buildup a business, maybe one only contributed labor, and then they sell it and they have capital gains goodwill on the sale of the business.

We should preserve taxing that at a capital gains rate. The Joint Committee on Taxation report explains how that is different from carried interest. It is fairly clear why it is.

The other, which is one you might overlook, is if somebody is building up intellectual property in the nature of patent rights. If you as an individual create a patent right, unlike a copyright, you have capital gains when you sell it. We should preserve that just to preserve continuity between the treatment of partnerships and individuals.

Mr. BECERRA. Appreciate that. Do investment fund managers that are able to take advantage of carried interest today have differing levels of risk in what they do as general partners based on the type of investment that is made?

Do some investment managers who are general partners—let me ask this question of Mr. Orszag—carry different levels of risk in

what they do as opposed to other fund managers who are general partners in a different type of investment?

Mr. ORSZAG. Sure; yes.

Mr. BECERRA. Let's say there is a different level of risk. If a general manager carries risk, does that enhance the argument that that fund manager should be allowed to treat any compensation received as capital gains?

Mr. ORSZAG. I do not think that necessarily follows. Again, as I said in my oral remarks and in the written testimony, there is a whole variety of performance based compensation. A movie actor with a take on the movie revenue faces a different degree of risk than I do as a public servant on my income, hopefully. Yes, so far.

Yet that movie actor's compensation is taxed as ordinary income. The presence or lack thereof of risk, I do not think is the issue. The issue really is returns on capital invested and capital income, just because human capital faces risk does not mean it should necessarily be accorded capital income treatment.

Mr. LEVIN OF MICHIGAN. All right.

Mr. BECERRA. Thank you.

Mr. LEVIN. I have to make a comment.

Mr. LEVIN OF MICHIGAN. Wait. My colleagues have told me not to allow that. We will come back to you.

Mr. LEVIN. I want to make a comment on risk.

Mr. LEVIN OF MICHIGAN. Okay. I think others might, too, including me. There are so many of us on the majority side. I am going to do two for one. I think it is fair.

Mr. Doggett, you are next.

Mr. BECERRA. Thank you, Mr. Chairman, for yielding the time. I yield back. I thank the panel.

Mr. DOGGETT. Professor Gergen, I would like to explore with you the portion of your testimony that focused on how folks might try to circumvent the Levin bill.

Do you feel there is a need for any modification to it or other sections of the Code that it may not address to deal with someone who would claim goodwill as capital or would use these interest free loans as a way to get around the bill?

Mr. GERGEN. I think you should not try to fix the interest free loan. The problem is woven too deeply into the Code. I would not fix it, it is woven too deeply, and you do pick up some ordinary income and compensation if they go that route. They are really opting into Professor Fleischer's approach as a way of avoiding uncertainty.

On over valuation, you just say it has to be reasonable. That is about all you can say in legislation. Let Treasury write regulations.

On zero basis intangibles, again, I would just have Treasury say if you put in substantial intangibles with a zero basis, we are going to come look at you, and then trust that people will be conservative in trying to over value intangibles.

Mr. DOGGETT. Separate from the Levin bill, is there any action that we need to take to address circumvention by moving offshore?

Mr. GERGEN. I would defer to somebody who knows more about international tax than I do.

Mr. DOGGETT. Any of the others of you want to respond on the offshore issue?

[No response.]

As far as what the impact of this bill is in terms of economic stimulation, I think I understood your testimony, Dr. Steuerle, to be that it could have positive impact to approve the bill so long as the benefits are distributed to others that would be engaged in economic activity.

Mr. STEUERLE. Yes, Mr. Doggett. I was asked to testify with reference to the principles we apply to tax reform in general. Whether with respect to either capital income or labor income, we should try to provide a level rate of taxation. Where we tax some people very high and some people very low, as opposed to a more even level, assuming they are at the same income level, we actually make the economy less efficient.

Mr. DOGGETT. Thank you. Professor Gergen, you suggested that we needed to go beyond investment services. What other types of partnerships do you think the same principle should be applied to?

Mr. GERGEN. I think the right approach is to make it global and then back out what still should be capital gains. I just said goodwill on the sale of a business or liquidation or sale of an interest and capital gain from the sale of patents and similar rights.

I may have missed something, but be global and then back out. The other thing I would do is just write an exception for partnerships that are below a certain value of assets or income level. There is not going to be that much revenue there and then those small partnerships do not have to worry about the rule.

Mr. DOGGETT. You and Mr. Fleischer and Mr. Jones then agree that the Levin bill is ready to go as it is written?

Mr. GERGEN. No, I would broaden it. There are some technical defects that I do not want to bore you with.

Mr. DOGGETT. Mr. Fleischer.

Mr. FLEISCHER. Minor details aside, I think it is ready to go.

Mr. DOGGETT. Mr. Jones.

Mr. JONES. I do agree that to single out the service partners in one industry is probably not a good idea. We need to fix the whole topic of service partners. The Treasury Department has proposed some regulations which are not simple at all. This bill, if it applied more globally, I think that is what Professor Gergen means, should apply to all service partners regardless of the industry.

Mr. DOGGETT. Thank you. Thank you, Mr. Chairman. I think my time is up.

Mr. LEVIN OF MICHIGAN. Mr. Ryan. Then it will be Mr. Emanuel and Mr. Pomeroy.

Mr. RYAN. Thank you, Mr. Chairman.

Let me just ask you down the line, Peter on down, accepting for argument sake that we will tax carried interest as ordinary income on the private equity partners, the limited, would it not be appropriate tax principle and policy to then deduct that tax that is paid to the managers by the other partners?

Mr. ORSZAG. In general, yes. That would be the traditional tax policy.

Mr. STEUERLE. Yes.

Mr. JONES. Yes.

Mr. FLEISCHER. Yes.

Mr. GERGEN. It does not necessarily follow that you would but——

Mr. RYAN. Come on, we are on a roll. Everybody else is saying yes.

[Laughter.]

Mr. GERGEN. There is a strategy people could use where if you did not give them a deduction, they could get it anyway, called the circle of cash.

Mr. RYAN. Yes, I am familiar with it.

Mr. GERGEN. Even if you do not go get the deduction, you might as well give it to them.

Mr. RYAN. I realize the bill does not do that but let me ask you, Dr. Orszag, if this bill were to be amended as most people agree it ought to be if we want to follow regular tax principles and policy, what would happen to the score of this bill if this tax was deductible for the other partners?

Mr. ORSZAG. As you know, the score will be determined by the Joint Committee on Taxation.

Mr. RYAN. I know.

Mr. ORSZAG. I would just note the treatment of taxable—most limited partners, the ones who put in the financial capital, are not taxable entities in the United States. For those that are, it is a little bit complicated because it will have the deduction but then there are various limitations on the value of the deduction that Congress has adopted, including a floor and an overall limit, and then we have the alternative minimum tax.

Mr. RYAN. Sure.

Mr. ORSZAG. I have to defer to the Joint Committee on Taxation. Obviously——

Mr. RYAN. It would dramatically reduce the revenue raised by this bill if you applied——

Mr. ORSZAG. In general, a deduction that actually successfully flows through to the taxable limited partners would reduce the revenue effect.

Mr. RYAN. Mr. Levin, you seem to want to comment. I will give you a little bit of my time if you want.

Mr. LEVIN. No, I am in agreement with that.

Mr. RYAN. Let's go to the tax principle of taxing the money and not the man. Taxing the source of the income and not the individual of the income. By introducing this policy, does it not set a new precedent of taxing the recipient rather than the type of income from which it came?

Mr. ORSZAG. Again, I would be interested in the tax practitioners and the tax lawyers, but what I would say is I think the issue here from an analytical perspective is the characterization of the services that are provided by the general manager, and whether that is more in the form of compensation for services provided and not a return on capital. That is what I see as the key issue.

Mr. RYAN. Go ahead, Mr. Levin.

Mr. LEVIN. Yes, I think it does. If you broaden the bill as the Professor has proposed to cover all carried interest, or even to be broader and cover all sweat, what you are going to find is there are an awful lot of people whose capital gain is then converted to ordi-

nary income. For example, Sally starts a business and her father finances it and puts the money in and Sally has a carried interest.

Bill Gates starts a business and investors put money in but Bill Gates gets more of the stock than the money he put in would draw. He has a carried interest.

If we broaden the bill, we are going to find that carried interests arise throughout our economy. If we do not broaden the bill and we leave it like it is, then only certain carried interest, that is private equity, venture capital, real estate, are covered, and there is no reasoned rational distinction between those industries and the other industries.

Mr. RYAN. Thank you.

Mr. LEVIN OF MICHIGAN. I hate to do this, and we need to talk about that, but we need to follow the 3 minute rule.

Mr. Emanuel.

Mr. EMANUEL. Mr. Chairman, I will try to be quick here. First of all, having worked a little in this industry, I just want to note if you were writing a book, economic book, about America's economic history of the last 50 years, I do not think you could write just a chapter alone on the last 20 years about the role of both venture capital funds, hedge funds, and private equity and their contribution to making the American economy dis-competitive.

It has been all three of those sectors, venture capital, private equity, hedge funds. They have been enormous contributors to the competitiveness of the American economy as it stands worldwide.

Without going into a series of questions as it relates to carried interest, I have wrestled with this issue. I do think some of the activity has risk involved but also has capital risk involved. Some of the partners of those actually put their capital into the fund.

On the other hand, there is a recognition that they are getting paid a fee for a service they are providing as a general partner, which is what I think led to—I find this almost intriguing, and I know I am going to mispronounce it—Greg Mankiw's position, President Bush's former economic advisor, who said deferred compensation, even risky compensation, is still compensation and it should be taxed as such. The administration is on the wrong side of this issue.

Another economic advisor, the Chairman of the CATO Institute, economic advisor to President Reagan—I would be more than willing to have these guys as witnesses—said the share of investment profits are basically fees for managing other people's money.

Having worked with my own fair share of economic advisors to Presidents, they are scholars.

What I found more intriguing in all this is when Blackstone filed their IPO, the Blackstone IPO, and I quote from it, "We believe," and this is in their own words, obviously lawyers and accountants helped write this, "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, re-investing 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 provision of services."

This is what they filed with the Securities and Exchange Commission when they were doing their IPO, which somewhat acknowledges that they are getting paid a fee for a service, in their own words. Nobody asked them to do this. This was for the IPO.

I think the other two economic advisors noted there was a fee for a service. I do think what are the unintended consequences, what is going on in London, what is going on in Europe, what is going on in Asia as it relates to private equity, hedge funds, the ability of capital to move.

I think what we have here is a situation where the compensation for fund managers does reflect—one of the reasons we are trying to untangle this—is both activities. There is risk and there is also being paid for a service.

How you come up with a structure, a tax number, that reflects that activity is what we are trying to untangle here.

I was wondering if anybody would want to comment on do you really see this as a pure play that is a fee for service, do you see some risk, à la (a) the tradition of what we described, capital at risk, and (b) do you see that the only choice is one or the other and there is no other way to come up with an alternative?

Mr. LEVIN OF MICHIGAN. Let's do this because we are going to follow the 3-minute rule, if it is okay.

Mr. EMANUEL. Can we go to a three and a half minute rule? I got it, Sandy.

Mr. LEVIN OF MICHIGAN. You are already beyond three and a half minutes.

[Laughter.]

Mr. EMANUEL. Thank you for my Rosh Hashanah blessing, another half hour. Thank you, Sandy.

Mr. LEVIN OF MICHIGAN. Following general rules as best we could. These are good questions. I think now, Mr. Pomeroy, and then Mr. Tiberi, you are next.

Mr. Pomeroy, under this procedure, you are next for 3 minutes, without a blessing otherwise.

Mr. POMEROY. Thank you. I will try to follow up on the question very well posed by my colleague.

Mr. Steuerle, you indicate as a principle of taxation, labor income should be taxed similarly regardless of source. That would indicate along the line of what Mr. Emanuel was asking.

Income related to a fee charged for a service, that is labor income. The rationale to have that taxed at capital gains or corporate dividend rates versus ordinary income rates does not exist.

Would you care to elaborate?

Mr. STEUERLE. Yes, Mr. Pomeroy. It seems to me there are two things going on that are causing the conflict here. One is that the Congress has decided at various stages to try to tax capital income different than labor income. The second is we have adopted in the partnership and sole proprietorship world a simplification that says we often cannot distinguish capital from labor income, so for certain purposes, we are going to treat them the same.

Those two are coming into conflict, and that is part of the debate.

I would just remind the Members of the Committee that on the flip side of that simplification, there are many people who are sole proprietors and partners who are very entrepreneurial, who are not

only paying full labor tax on their labor income, but in fact on their capital income from investments, the equipment they buy actually flows through income on which they pay Social Security tax.

Thus on the one side in this partnership form, we have some people who are paying 45 percent tax rates on their capital income and on the other side, we have some people who are paying 15 percent tax rates on their labor income.

That is the conflict that you are trying to deal with here.

Mr. POMEROY. In the district I represent, we have a lot of people that fall in that latter category that you speak of.

At the time the differential was created, I was on this Committee. We were told the national savings rate was going to go up because people suddenly saved to invest. We heard this morning that the national savings rate has been negatively impacted to the tune of better than 1 percent by those very reforms creating the differential, and now we have a differential that people are gaming.

In the last 30 seconds of my time, Mr. Orszag, what is the budgetary impact from this, basically, taxation of labor at the capital gains rate?

Mr. ORSZAG. As I said before, the score for any change in that current tax treatment would come from the Joint Committee on Taxation, which has not yet released an analysis. I will leave it to them for that.

Mr. POMEROY. Thank you, Mr. Chairman. I yield back.

Mr. LEVIN OF MICHIGAN. Mr. Tiberi.

Mr. TIBERI. Thank you, Mr. Chairman.

Mr. Levin, you had tried to make a point earlier regarding partnership risk, and you were unable to further make that point. If you could clarify that, and the second question is, can you comment on how this is taxed, how carried interest is taxed in competing countries, where capital obviously might flow if we tax it here, in Europe, in Asia, primarily?

Mr. LEVIN. Yes. First, the point I wanted to make on risk is that risk is essential for capital gain; when you look at the capital gain sections of the Code, it is gain from the sale of an asset, capital asset, held more than 12 months. That is stocks, real estate, things you invest in and take a risk on.

Risk is essential to capital gain, but risk is not always sufficient. There are circumstances if you are an executive at a company, at a corporation, and you are given a bonus that is contingent on sales, you have a risk, but that does not give you capital gain.

The key in the Code has always been a capital asset held for more than 12 months, and what this bill seeks to do is to change that rule. Once you change it, there are ever so many other changes you can make. You put a lot of things at play, and you are not sure where you are going to come out.

Secondly, you asked about other countries. In the vast majority of countries that I am familiar with, there is a differential between capital gain and ordinary income, higher rate for ordinary income than capital gain.

In the vast majority of the countries that I am familiar with, where you have a partnership arrangement, like a private equity fund, with capital gain flowing through to the people who run the fund, they get capital gain. U.K. is one of those.

One can point out that since this country began its careful re-examination of this, other countries such as the U.K. have announced they are going to re-examine it. It does not mean they are going to change it any more than we are going to change it, but it would be, I think, a pity for us to change it, tax capital gain carried interest as ordinary income if other countries do not.

I think there will be some leakage then of money into funds in other countries. That is a complex issue of where do the general partners pay tax, where is the fund formed, but there will be some, in my opinion, leakage of money out of this country.

Mr. TIBERI. Dr. Orszag.

Mr. ORSZAG. I would just add very quickly that the issues facing many other countries are different from the ones facing the United States because of the way that we tax U.S. citizens. That differs from the way, for example, the United Kingdom taxes its citizens, and the tradeoff's that the U.K. Government may face in changing its tax treatment differ from those that the United States faces.

Mr. LEVIN OF MICHIGAN. By the way, England is also facing this issue. We are not the only ones.

Mr. CAMP. If the gentleman will yield, Mr. Tiberi.

Mr. LEVIN OF MICHIGAN. His time is up. If we might, Mr. Thompson is next.

Mr. THOMPSON. Thank you, Mr. Chairman. Thank you to all the witnesses.

Mr. Levin, I have heard from folks, and I think we are going to hear in the next panel from the real estate community, that the issue, the tax treatment of carried interest is an incentive to revitalize areas that are poor or economically disadvantaged or under served.

If we do in fact alter this carried interest or do away with it, what is the impact going to be, in your view?

Mr. LEVIN. I think it is the same as I talked about for private equity and hedge funds and venture capital, that is, if you increase markedly the taxation on the general partners, who devise the projects, operate the funds, make the investments and act as principals, and only give capital gain to the passive investors, it seems to me that it is almost upside down, and you do give a disincentive as compared to where things are now for people to redevelop or make investments.

I cannot tell you that there is going to be a 90-percent reduction, but I can tell you I believe there will be a 10- or 20- or 30-percent reduction in some of these investments, and that alone is enough to harm the growth of our economy.

Mr. THOMPSON. We have heard it argued that fund managers can easily convert their fee income into carried interest, and this is a question for anyone who wants to take a shot at it.

How easy is it really for such a fee to be converted and how often is this being done?

Mr. LEVIN OF MICHIGAN. Professor Fleischer.

Mr. FLEISCHER. You can look in Mr. Levin's book for a guideline on how to do it. It has become quite common. The fund managers do have to take some economic risk in order to get the tax treatment that they want, but it is not as much risk as you might

imagine. They take a priority allocation of the next year's profits, so they have to wait a few more months, instead of getting their management fee in 1 year, they have to wait a few more months, and then they get it in capital gains terms in the next year.

Mr. THOMPSON. Anyone else want to take a shot?

Mr. LEVIN. I would just comment that I think it is substantial risk.

Mr. STEUERLE. May I just add there is no principle in the Tax Code for subsidizing risk per se. Risk can be good or bad. Risk is not good in and of itself.

Mr. THOMPSON. Thank you. I yield back.

Mr. LEVIN OF MICHIGAN. Who is next? I think it is Mr. Blumenauer.

Mr. BLUMENAUER. Thank you, Mr. Chairman.

First, on behalf of my friend, Mr. Emanuel, I wanted to indicate that if any of you folks wanted to make a reaction to this question and have it entered in the record, he would appreciate it.

We have heard from Mr. Levin about the negative potential impacts on these extraordinarily highly skilled people who are managing these investments if we change the rules of the game and tax them more like most Americans are taxed, that it would have some effect on their behavior.

I guess I am more interested about what are the effects on the millions of Americans, and Dr. Steuerle, you alluded to it in your testimony, lots of people are paying actually much higher marginal rates, under more difficult circumstances with less resources to cope with.

I am curious if you have any thoughts about are they less sensitive to price signals? Are they less bright, that they do not know about it? If you multiply these millions of people who are presumably productive, at least at some level, paying these very high marginal rates, does that not have some impact on our society, as well in terms of the economy and what happens to them, not in a moral sense, but in practical dollars and cents, in terms of how the economy behaves?

Mr. STEUERLE. Yes. One of the principles of tax policy is that some of the greatest inefficiencies or distortions are caused when the rates are the highest. That means that often the people we want to look at most, if we are trying to provide relief, are the people who pay the highest marginal tax rates on their investment.

I alluded to several of them in my testimony, including the kid who is putting money in a savings account to pay for college. That person is taking risk. He might be an entrepreneur. There are also small businesspeople. There are cleaning ladies. There are people who provide all sorts of home services. They are in businesses and they are undertaking entrepreneurial risk.

It is very difficult to justify subsidizing some groups at very low rates just simply because they have high incomes and therefore can afford a bit better some lobbyists to favor them.

Mr. BLUMENAUER. Mr. Chairman, at some point, as we move forward with this discussion as a Committee, I would like to see if there is a way to frame this, about the people in society who are at the edge, who are paying higher marginal rates, and the impact that the tax system has on them. I hope at the end of the day we

are able not to pick winners and losers; to the contrary, that we are able to even this out in some fashion.

I appreciated the reference that Dr. Steuerle had, and I would hope there would be a way for us to focus in on that, maybe gather a little more information and actually talk about it.

Mr. LEVIN OF MICHIGAN. I hope we will. This is not an effort to pick winners or losers.

There has been general agreement that we are going to go to the next panel before we lose it, except Mr. McCrery has agreed, and he will go next.

Mr. Pascrell, I understand you have a 30-second question. Go ahead.

Mr. PASCRELL. Mr. Chairman, before I do that, I know our back sides are sore, but our spirits are liberated. This is such a refreshing thing that has happened in the last 6 years. We have reporters at the table. We have firemen at the table. We have money managers and laborers at the table.

We are going to get a fair shot here down the road.

Mr. Levin, in your book on pages 10–15 (of the 2007 edition)——

Mr. LEVIN OF MICHIGAN. Which book?

[Laughter.]

Mr. PASCRELL. The book is "Structuring Venture Capital and Private Equity" et cetera.

Mr. LEVIN OF MICHIGAN. I only say that because I have five books. Sorry.

We have just limited time.

Mr. PASCRELL. You describe a situation in which an investment fund manager can waive a portion of its management fee in exchange for an increased allocation of the fund profits, stating that "This technique should convert management fee income which would have been taxed as ordinary income into long-term capital gain."

Does the ease with which the author describes the investment which can be converted for compensation income into capital gains trouble anybody on this panel?

Mr. Gergen.

Mr. GERGEN. Yes.

Mr. PASCRELL. How does it trouble you?

Mr. GERGEN. Fairness and efficiency. We have talked about it the last hour and a half.

Mr. LEVIN OF MICHIGAN. We are going to go down the row very quickly. Mr. Fleischer.

Mr. FLEISCHER. It is quite troubling, and the economic risk that the fund manager has to take is not in many cases so substantial because the fund manager knows the assets in the portfolio that might be realized in that next year.

Mr. PASCRELL. Mr. Jones.

Mr. JONES. That is right; what Victor just said is absolutely correct. Risk has nothing to do with it in any event, but there is no real risk. They wait until they about know what their profits are going to be and then they exercise their options.

Mr. PASCRELL. I want to thank each of the members of the panel, everybody; you guys did a fantastic job, and I really appreciate it. Thank you very much.

Mr. LEVIN OF MICHIGAN. With that note, and I think we all agree, thank you very, very much. This has been really informative.

Now, our last panel, the most patient people in Washington, let's go. As you come forth, I am going to introduce you.

Leo Hindery, who is the Managing Director of InterMedia Partners in New York. Mr. Stanfill, who is the founding partner of TrailHead Ventures in Denver. Orin Kramer of the New Jersey State Investment Council. Jonathan Silver, Managing Director of Core Capital Partners. Adam Ifshin of DLC, and Bruce Rosenblum.

It may not be in that order. We will take you in the order you are seated.

Mr. LEVIN OF MICHIGAN. Each of you has 5 minutes now. I do not think we need to apologize. I think you probably know, some of you are veterans of these battles, that being the fourth panel meant it might be a less prominent place, but it really is not.

We are going to do two things, make sure everybody sees your testimony, and we will distribute it through the Committee directly, and secondly, this is just the first of our discussions, and we will probably be tapping you in the future.

I introduced you as you were walking up. Each take your 5 minutes. We will go from there.

Mr. Hindery, we are going to start with you.

STATEMENT OF LEO HINDERY, JR., MANAGING DIRECTOR, INTERMEDIA PARTNERS

Mr. HINDERY. Thank you, Mr. Chairman, and Members for convening this important hearing, as late in the day that it is, its importance justifies our being here.

As many of my colleagues have commented today, at the onset, I speak only for myself and certainly not my firm. As you will hear from my comments, many would think I do not speak for my industry as well.

I am the Managing Partner of InterMedia Partners, which is a private equity firm I formed in 1988, and I ran continuously until 1997 when I became the chief executive officer of Telecommunications, Inc. or TCI, and later, its successor, AT&T Broadband.

I returned full time to private equity in 2001, and my business career includes nearly 20 years of direct and indirect involvement with investment partnerships. As a consequence, I am intimately familiar with their history, their realities and their economics.

As we have heard often today, hundreds of thousands of Americans throughout the U.S. economy work hard every day managing things for other people, ranging from grocery stores to gas stations to money.

All of these managers earn a base level of compensation and in addition, most of them earn some form of performance fee. Except for one group of individuals, all of them pay ordinary income taxes on their personally earned management income.

I am here today to talk about the management income being earned by that one particular group, namely those women and men, of whom I am one, who use special purpose investment partnerships to manage money belonging to others.

The management income which we earn, which we call "carried interest," is taxed as capital gains, when I and others believe it should instead be taxed as ordinary income.

Of course, because the 15 percent capital gains tax rate is less than half, the 35 percent maximum ordinary income tax rate paid by virtually every other manager and by regular Americans, how this issue is resolved will have an enormous impact on the nation's tax receipts on the order, as we have heard, of $12 billion a year.

The reason this tax loss figure is so high is simply because of the magnitude of the earnings which are now escaping ordinary income taxation.

To fully appreciate this, all this Committee has to do is reflect on the fact that in 2006, the top 20 hedge fund and private equity managers in America earned an average of $658 million a piece. That is 22,255 times the pay of the average U.S. worker, and of course, most of these earnings were taxed at just the 15-percent rate.

I should note that my concern today is not about the taxation of the operating income earned by any of these special purpose partnerships, although there is very substantial inconsistency and thus abuse in how income from operations is currently being taxed from one type of partnership to another.

I should further note that while much of the public's attention to this issue has been directed at hedge funds and private equity managers, the management income earned by managers of all investment partnerships needs to be scrutinized alike, hedge funds, private equity, oil and gas, real estate and timber.

It really is not all that hard to decide how to properly tax carried interest. Is carried interest income which a money earns on his or her personal investments or instead is it the performance fee earned for managing other people's investments?

If carried interest is personal investment income, then it is properly entitled to capital gains treatment. However, if it is a performance fee, and my 20 years of firsthand experience clearly tells me it is, then it should be taxed as ordinary income.

Simply put, Members, a very bright line needs to be drawn between investor type partners who invest their own money and are thus entitled to capital gains treatment on the investment income they earn and manager type partners who contribute only their services.

A prominent private equity manager recently contended to this Congress that investment manager earnings are "Capital gains in every technical and spiritual sense."

All I can say in answer is no church or synagogue I know would consider it very spiritual to each year selfishly characterize as capital gains literally billions of dollars of management income that has absolutely no down side risk to the managers, especially when doing so comes at such a great expense to the rest of our Nation's taxpayers.

On the issue of risk, about which much has been said today, I would note that there is a very, very big difference between the risk of losing one's money, which is real risk, and the risk of not making as much as you hoped, which is not risk in any meaningful way.

Some of my fellow investment partnership managers also say that this hearing is nothing more than a vindictive singling out of their firms because of their extraordinary success, and they say that increasing the tax rate on their earnings to the ordinary income level will create an investment tax of sorts with dire, dire unintended consequence for the entities whose money is being managed and for the American economy.

These conclusions are self serving and they are poppycock. Congress is not considering changing the tax rates on the investments made by investors. Congress is only considering restoring fairness in how the women and men who manage these investments are individually taxed compared to other managers and to regular workers.

It is beyond disingenuous to predict dire unintended consequences when no consequences at all will occur.

A tax loop hole the size of a Mac truck is right now generating unwarranted and unfair windfalls to a privileged group of money managers and to no one's surprise, these individuals are driving right through this $12 billion a year hole.

Congress, starting with this Committee, needs to tax money management income, what we call "carried interest," as what it is, which is simply plain old ordinary income.

I hope, Mr. Chairman and Members, that my comments have been helpful. I look forward to your comments and your questions. Thank you, Mr. Chairman.

[The prepared statement of Mr. Hindery follows:]

Prepared Statement of Leo Hindery, Jr., Managing Director, InterMedia Partners, New York, New York

Thank you, Mr. Chairman and Members, for convening this important hearing on the taxation of carried interest for investment partnerships.

I am Leo Hindery, and I am the Managing Partner of InterMedia Partners, a private equity fund which I formed in 1988 and ran continuously until 1997 when I became CEO of Tele-Communications, Inc. (TCI) and later its successor AT&T Broadband. I returned full time to private equity in 2001. My business career includes nearly 20 years of direct and indirect involvement with investment partnerships, and I am intimately familiar with their history, realities and economics.

Hundreds of thousands of Americans throughout the U.S. economy work hard every day managing things for other people, ranging from grocery stores to gas stations to money. All of these managers earn a base level of compensation, and in addition, most of them earn some form of performance fee. And except for one group of individuals, all of them pay ordinary income taxes on their personally earned management income.

I am here today to talk about the management income being earned by that one particular group, namely those women and men, of whom I am one, who, using special purpose investment partnerships, manage money belonging to others. The management income which we earn, which we call carried interest, is taxed as capital gains, when I and others believe it should instead be taxed as ordinary income.

And of course because the 15 percent capital gains tax rate is *less than half* the 35 percent maximum ordinary income tax rate paid by virtually every other manager and by regular Americans, how this issue is resolved will have an enormous impact on the nation's tax receipts, on the order of $12 billion a year.

This reason this taxes loss figure is so high is simply because of the magnitude of the earnings which are now escaping ordinary income taxation. To fully appreciate this, all this Committee has to do is reflect on the fact that in 2006, the top 20 hedge fund and private equity managers in America earned an average of $658 million each, which is 22,255 times the pay of the average U.S. worker. And of course all of these earnings were taxed at just a 15 percent rate.

I should note that my concern today is not about the taxation of the operating income earned by any of these special purpose partnerships, although there is very

substantial inconsistency and thus abuse in how income from operations is currently being taxed from one type of partnership to another.

And I should further note that while much of the public's attention to this issue has been directed at hedge fund and private equity managers, the management income earned by managers of all investment partnerships needs to be scrutinized alike: hedge fund, private equity, oil-and-gas, real-estate, and timber.

It really isn't all that hard to decide how to properly tax carried interest. Is carried interest income which a money manager earns on his or her personal investments, or, instead, is it the performance fee earned for managing other people's investments? If carried interest is personal investment income, then it is properly entitled to capital gains treatment—however, if it is a performance fee, as my 20 years of first-hand experience clearly tells me it is, then it should be taxed as ordinary income.

Simply put, a very bright line needs to be drawn between investor-type partners who invest their own money and are thus entitled to capital gains treatment on the investment income they earn, and manager-type partners who contribute only their services.

A prominent private equity manager recently contended to this Congress that investment managers' earnings are (and I quote) "capital gains in every technical and *spiritual* sense" (unquote). All I can say in answer is that no church or synagogue I know would consider it very "spiritual" to each year selfishly characterize, as capital gains, billions of dollars of management income that has absolutely no downside risk to the managers, especially when doing so comes at such a great cost to the rest of our nation's taxpayers.

Some of my fellow investment partnership managers also say that this Hearing is nothing more than a vindictive singling out of their firms because of their extraordinary success. And they say that increasing the tax rate on their earnings to the ordinary income level will create an "investment tax", of sorts, with dire unintended consequences for the entities whose money is being managed and for the American economy.

These conclusions are similarly self-serving, and they are complete poppycock.

Congress is *not* considering changing the tax rates on the investments made by investors. Congress is *only* considering restoring fairness in how the men and women who manage these investments are individually taxed compared to other managers and to regular workers. And it is beyond disingenuous to predict dire unintended consequences when no consequences at all will occur.

A tax loophole the size of a Mack truck is right now generating unwarranted and unfair windfalls to a privileged group of money managers, and, to no one's surprise, these individuals are driving right through this $12 billion-a-year hole. Congress, starting with this Committee, needs to tax money management income, what we call carried interest, as what it is, which is plain old ordinary income.

I hope my comments have been helpful. Thank you very much for this opportunity to speak with you today, and I welcome your questions.

Chairman RANGEL. [Presiding] I apologize for not being here. We really want to thank this panel. We had no idea that the hearing was going to last this long. We thank you so much for your patience.

I want to make it abundantly clear that it came to the attention of this Committee, both the Ranking Member and I, that we had a moral, political, legislative obligation to eliminate the alternative minimum tax. We agreed to that.

Our problem was how do you do it and how do you pay for it. In the course of these hearings, anyone that has said that the Chair or any Members were out to raise taxes or to attack, yes, we said loop holes, yes, we said we want to simplify the Tax Code. Yes, we want to say we want to make it revenue neutral.

I am really amazed as to people who believe that the difference between 15 percent in capital gains tax rate and 35 percent tax rate, that we should leave it alone or that we are attacking people, I have never seen anyone that is not even on the agenda, except

that we are looking at everything in the Code, scream so loud when no one even mentioned their names.

Naturally, we want experts like you to share your opinion so that we do not do anything dramatically, but it is not the intention of this Committee to continue to be just a revenue raising Committee.

We want to simplify the Code. We want to make certain that economically it provides incentives necessary for the economy, and we have to have it perceived as being fair and equitable by all taxpayers.

I only say that because we just left a meeting where people said we wanted to tax the rich and all of that. I just want to get us back on target. It started out how do you eliminate the alternative minimum tax on 23 million people, and the answer is with great difficulty.

We are moving. I want to thank you once again for your patience.

William Stanfill, founding partner of TrailHead Ventures. Thank you for being here.

STATEMENT OF WILLIAM D. STANFILL, FOUNDING PARTNER, TRAILHEAD VENTURES

Mr. STANFILL. Chairman Rangel, Ranking Member McCrery, and Members of the Committee, as the Chair noted, my name is William D. Stanfill, founding partner and head of the Denver office of Trailhead Ventures, a private venture capital partnership investing in information technology.

At the outset, I would like to make clear that I speak not on behalf of my firm, and certainly not on behalf of the industry. Rather, I speak as a private citizen who has been involved in venture capital for 25 years.

Beginning in 1982, I was responsible for a fund of funds that invested in 30 venture partnerships. In turn, those partnerships invested in some 600 to 700 venture backed companies. These portfolio companies were scattered across the U.S. from coast to coast, from Massachusetts to California. I have read the earlier Senate testimony about the wonderful things that we venture capitalists do. I think this is an idealized version of our industry, a vision of the Wizard of Oz comes to mind.

Those venture capitalists and I do the same kind of work. We just come to different conclusions about what is appropriate tax treatment for our earnings.

All workers add value to a greater or lesser extent. Randy Testa is a gifted teacher. He inspired and challenged our son, David, and his third grade classmates, developing and enriching human capital. Yet, the tax rate on my carried interest is less than the tax rate on his salary.

There has been more than a hint of Chicken Little in the dire predictions of the havoc this tax change will cause. In my judgment, they will not come to pass any more than the end of the automobile industry, which was predicted when seat belts and emission standards were mandated.

I do not think many if any firms will move offshore or if they do, they will be motivated by investment opportunity as opposed to tax

treatment. We have always found plenty of investment opportunities in our own backyard.

Or that limited partners will stop investing. This change does not affect their taxes. Most of them are tax exempt entities anyway.

I do not think losing the carried interest tax break would drive other venture capitalists out of the field. We get ample compensation, financial and psychic, for the work we do and the risks we take with other people's money, by the way, in the form of a share of profits.

I have been in the business for 25 years and the basic compensation structure of 2 and 20 has survived all of the tax changes over that time.

How long will we tolerate the ever widening gap between rich and poor? Although my preference is for major tax reform, I do believe it is fair, equitable and appropriate to work on the issue of tax equity where we can.

We should not do nothing because we cannot do everything. I am especially disturbed by suggestions that we cannot afford to provide health insurance for low income children or first rate medical care for our injured soldiers.

I am disturbed that these and other human priorities are unaddressed, while we pretend we can afford to continue these tax breaks.

In conclusion, our earnings are compensation and should be taxed the same way the compensation of everyone else is in the country. It is neither fair nor just for teachers and firefighters to subsidize special interest tax breaks that cost billions of dollars each year. It is unacceptable that those tax breaks also rob the Medicare system of much needed revenue. We and our representatives in Congress have a choice. We can change the Tax Code in favor of equity and fairness or we can come to the same conclusion reached by Walt Kelly and his mouth piece, Pogo. We have met the enemy and he is us. I would be happy to entertain your questions.

Thank you.

[The prepared statement of Mr. Stanfill follows:]

Prepared Statement of William D. Stanfill, Founding Partner, TrailHead Ventures, Denver, Colorado

Chairman Rangel, Ranking Member McCrery, and Members of the Committee, my name is William Deming Stanfill, founding partner and head of the Denver office of Trailhead Ventures, a private venture capital partnership whose investment focus is information technology. At the outset, I would like to make clear that I speak not on behalf of my firm and certainly not on behalf of the industry. Rather I speak as a private citizen who has been involved in the venture capital industry for 25 years.

I joined the Centennial Funds of Denver in 1982 and was responsible for a fund of funds activity wherein we invested in thirty venture partnerships around the United States. The venture partnerships collectively invested in 600–700 portfolio companies including telecommunications, medical, and information technology. Those portfolio companies were scattered across the U.S., from Massachusetts to California, Florida to Oregon, Colorado and Utah, Arizona, Texas, and New Mexico, Alabama and Georgia, Idaho and New Hampshire.

What We Do

In 1995, I left the Centennial Funds, purchased the fund-of-fund activity and formed Trailhead Ventures to invest directly in early stage information technology enterprises. By industry standards we are a small fund. Our advantage is our ability to provide seed and early-stage capital of $2–4 million to start-up companies. A $500 million partnership, by contrast, cannot manage 125 to 250 investments of $2–

4 million each. Our limited partners include state and corporate retirement funds, university endowments, and the occasional high net worth individual.

Basically we back entrepreneurs who have good ideas and an obsession to bring them to market. We help surround the entrepreneur with a world-class management team. If the team performs well, we have the good sense to stay out of their way. The last thing most venture capitalists want is for the management team to hand them the keys to the enterprise. That said, we serve on boards, assist with business strategy, help interview and select members of the senior leadership team, and introduce the entrepreneurs to professional and other service providers who can bring value to the enterprise.

How We Are Compensated

We receive a management fee, based on a percentage of committed capital, to cover salaries and expenses. After payback, when limited partners have recouped their investment, we then share in the profits on an 80/20 split. This is the "carried interest." Both the management fee and the carried interest represent compensation for the work that we do. The general partners also invest at least 1 percent of the fund's capital. The earnings on that 1 percent are, of course, not compensation, but qualify for capital gains treatment along with our investors' earnings.

How Our Compensation is Taxed

Our management fee is taxed as ordinary income. However, the carried interest, even though it is compensation, is primarily taxed at capital gains rates. I can understand why many in my industry want to preserve this special tax advantage. Clearly, it has served U.S. and ME well. The tax subsidy each year to private equity fund, hedge fund, and venture capital fund managers is in the *billions* of dollars. But I think this special tax break is neither fair nor equitable.

All workers add value—to a greater or lesser extent. Randy Testa is a gifted teacher—he inspired and challenged my son David and his third grade classmates—enriching *human* capital. But the tax rate on my carried interest is less than the tax rate on his earnings. Or how about the veterans of the Iraq war, in particular the 26,000 casualties? Do I deserve a tax break more than they do? Ben Stein doesn't think so. Nor do I.

Many Americans invest sweat equity in their jobs and their businesses, take risks, contribute to the economy, and may have to wait a long time before their hard works pays off. But they still pay ordinary income tax rates on their compensation. To the extent we take risk, we take it with other people's money. As Bill Gross, the managing director of PIMCO Bond Fund noted, "[w]ealth has always gravitated towards those that take risk with other people's money but especially so when taxes are low."

In addition to the lower income tax rate on the compensation earned in the form of carried interests, this income is also earned free of payroll taxes. The revenue cost to Medicare is estimated to be about a billion dollars a year. This is unacceptable at a time when the aging American population depends increasingly on the services provided by Medicare and when the Hospital Trust Fund is expected to experience substantial shortfalls in just a few years.

Consequences of Changing the Tax Treatment

I don't think that changing the tax law to require me and other managers of venture capital firms, private equity firms, and hedge funds to pay tax on our compensation like other working taxpayers would have the dire consequences that some are predicting.

Many predict that firms will locate overseas, taking jobs and tax revenue out of the country. My firm is too small to play in the international field—the learning curve is too steep and the expenses are too high. And if you are doing seed investing, we've always found sufficient deals in our own backyard. And my accountant advises me that, even if we did move our fund offshore, as a U.S. citizen I would still be subject to U.S. tax on my income.

I don't see why my limited partners would stop investing in our fund just because my tax treatment changes. It doesn't affect their taxes—most of them are non-taxable entities anyway. If my investors ask me what this tax change means to them, I'm going to tell them "nothing." And I'd still have a strong incentive to do the best for my investors. After all, I don't earn profits until they do. I have been in the business for 25 years and the base compensation structure of 2 and 20 has survived all of the tax changes over that time.

What limited partners should expect from a venture capital investment is a 500 basis point (5 percent) premium over a portfolio of publicly-traded securities. And that premium is not a risk premium, but a premium for illiquidity. Why? Because we are a 10-year partnership. But in addition to that premium, the investor gets

a lottery ticket and the results can be substantial. In the first Trailhead Fund, we have produced a 54 percent internal rate of return net to the investor and if we liquidated the remaining public securities today, we would return 10 to 11 times our partners' capital.

I have read the statements by others in my industry defending the special tax treatment of our earnings by talking about the wonderful things we venture capitalists do. I think this is an idealized view of our industry—a vision of the Wizard of Oz comes to mind. We don't lead every deal in which we invest. Occasionally we are followers, along for the ride. Am I the only one who finds these claims just a bit self-serving?

What is interesting about early-stage venture investing is the rewarding collaboration between the limited partners who bring dollars and trust, the venture capitalist who brings judgment and experience, and the entrepreneur who brings an idea and a fire in his or her belly. That combination can create wonderful, profitable results. But there is a first among equals here that we should never forget, and is the key to the equation, and that is the entrepreneur.

I have loved my work over the last 25 years and I would not stop doing it because my tax rate was adjusted to the level of other citizens'. And I don't think losing the carried interest tax break would drive other venture capitalists out of the field. We like the excitement and satisfaction of assisting management in transforming good ideas into successful businesses. We get ample compensation, financial and psychic, for the work we do and the risks we take, in the form of a share of the profits. There is more than a hint of Chicken Little here. But our industry won't end or be significantly disrupted if this legislation is enacted any more than the auto industry's dire predictions of doom came to pass after mileage standards, seatbelts, and air bags were mandated.

Does Venture Capital Deserve Special Tax Breaks?

I could make a public policy case for excluding venture capital from this legislation. For unlike private equity and hedge funds, the venture capital industry does create jobs. We fund small start-ups rather than restructure huge companies. And we don't use leverage to pay ourselves back and leave the portfolio companies saddled with debt. But I won't. I still think our earnings are compensation and should be taxed the same as the compensation of everyone else in this country—from teachers and firefighters to athletes and movie stars. I don't think it is fair for those teachers and firefighters to subsidize special tax breaks for me and other venture capitalists. Or for private equity and hedge fund managers.

Wealth Inequality

How long will we tolerate the ever-widening gap between rich and poor? Though my preference is for major tax reform—increased standard deductions, a base rate for all income: wages, salaries, dividends, royalties, and capital gains with some progressivity built in—major tax reform is not on your agenda. However, I do believe it is fair, equitable, and appropriate to attack the issue of tax equity at the margins. We should not do nothing because we can't do everything. I am especially disturbed by suggestions that we can't afford to provide health insurance for low income children, first rate medical care for our injured soldiers or fund—at the Federal level—the mandates of No Child Left Behind. I am disturbed that these and other human priorities are unaddressed while we pretend we can afford to continue these tax breaks.

Conclusion

I'm delighted to be part of the venture capital business—it's been a wonderful 25 years. We funded a lot of companies—many of them successful. We've worked hard and I think we've earned our compensation. My point simply is that fairness and equity dictate that we pay ordinary tax rates on that compensation.

Was Ben Franklin prescient when he warned us that our republic would fail because of corruption, greed, and, dare I say it, special interests? Doesn't gross inequity in our Tax Code, maintained by the very people who benefit from it, come close to the same thing? We and our representatives have a choice. We can change the Tax Code in favor of equity and fairness. Or we can come to the same conclusion reached by Walt Kelly and his mouthpiece, Pogo, "we have met the enemy and he is us."

Thank you and I would be pleased to answer any questions.

Chairman RANGEL. Thank you so much. Now it is my pleasure to welcome an old friend, and he will have to share with me how the New Jersey State Investment Council is located in New York, New York, but as long as it is there, it is okay with me.

Chairman Kramer, welcome.

STATEMENT OF ORIN S. KRAMER, CHAIRMAN, NEW JERSEY STATE INVESTMENT COUNCIL

Mr. KRAMER. That is where your office found me, Mr. Chairman. Mr. Chairman, Mr. Ranking Member, Members of the Committee, can I ask in the interest of time, which has to be a priority of yours, that my brief comments be entered into the record, and I will just summarize.

Chairman RANGEL. Thank you. Without objection, and for all of those that have been patient, as you have been, again, I apologize for the lateness, but your entire statements will be in the record. Please feel free, if there are additional remarks that you would like to bring before the Committee, we would welcome them.

Mr. KRAMER. I am happy to answer any questions. Briefly, I am Chair of the Oversight Board of the Jersey Pension System. It is an $80 billion system. I think it is the ninth largest pension fund in the United States.

In my private life, I manage a hedge fund, and therefore, I benefit from the lower capital gains treatment, which I try to get as much of as I can, on carried interest.

I am happy if you want during Q&A to go into the broader philosophical issues, but I have been asked to address the narrow question of whether higher tax rates for private equity and hedge funds would be detrimental to public pension funds and therefore to those retired teachers and police officers and so forth.

Leaving aside the question of what the appropriate tax treatment is and how we should think about capital gains versus ordinary income, in simple terms, in competitive markets, basically firms cannot automatically pass their costs on to their customers, and it is actually no different in the money management business than in any other business, whether it is higher rents or higher costs of recruiting somebody away from his firm, or higher taxes, whatever creates higher operating costs.

The fees are essentially set by the market. There are some firms that charge more than the standard 2 and 20. The firms that charge more than the standard 2 and 20 do it because (a) they want to and (b) there is some pool of investors for them who say I think I am going to get a high enough return that it is worth paying 3 and 40. I suspect there are more people who would charge 3 and 40 if there were more investors who were willing to pay 3 and 40.

If people get enamored of the returns, maybe someday people, a lot of people, will be paying 3 and 40. If returns go south, maybe someday people will be paying 1 and 10.

I think it is a function of market forces and not where you set your tax rates. Actually, having worked in this city when Chairman Rangel was already an important Member, when I was working up the street 30 years ago, and actually back then, the capital gains rates were higher. The marginal rates on the top income

earners were higher than they are today. Money managers made much less money than they make today.

Today, we have much lower rates, marginal rates, my top rate. We have lower rates on capital gains. We have this record number of money managers who are charging fees that were inconceivable when I last worked in this city.

Actually, if we look at history, we say there must be this inverse relationship between the level of fees and the level of tax rates because they have gone in the opposite directions, but enough.

[The prepared statement of Mr. Kramer follows:]

Prepared Statement of Orin S. Kramer, Chairman, New Jersey State Investment Council, New York, New York

My name is Orin Kramer. I am chair of the New Jersey State Investment Council, which is the fiduciary board overseeing the state's $80 billion public pension system. At last count, New Jersey was the ninth largest public pension fund in the United States. In my private life, I manage a hedge fund. I have served on the boards of various financial services firms and on presidential commissions and task forces. I have also been Executive Director of gubernatorial commissions in California and New York, spent four years on the policy staff of the Carter White House, taught at Columbia Law School, and published a variety of policy studies. The views expressed here are mine alone and should not be attributed to other members of the State Investment Council.

I have been asked to address the question of whether higher tax rates for private equity and hedge fund managers would be detrimental to public pension funds and their beneficiaries. As I understand it, the argument is that higher taxes are a cost which asset managers will pass on to clients, thereby diminishing client returns.

Thirty years ago when I worked in this city, tax rates on high income earners and capital gains were higher than today and fee levels generated by the top money managers were lower than today. Now we have lower marginal tax rates and an unprecedented number of people generating record fees from money management. So from a purely historical perspective, there seems to be an inverse relationship between tax rates and the fees clients permit us to charge for managing assets.

In my experience, private equity and hedge fund managers tend to be highly sophisticated about business economics, and they know that firms in competitive markets cannot automatically pass higher operating costs on to customers. I would be reluctant to entrust capital to an investment manager who did not share this view. Today the standard compensation arrangement for private equity and hedge firms is a 2 percent management fee plus 20 percent of profits, or the incentive fee. A small number of managers charge higher fees. They do so because it is their choice, and because there exist for those managers pools of investors who believe that their returns net of fees will justify the higher payments. Since the capitalist instinct among money managers appears to be robust, if asset managers believed that the institutional investor community would accept fees above the 2/20 arrangement, I suspect those fees would rise. But if asset managers choose to increase their level of personal consumption, or if they incur higher operating costs such as higher taxes, fees do not rise because the after-tax savings of money managers diminishes. Fees rise when the return expectations of limited partners increase, justifiably or not, to levels which warrant higher fees.

I can imagine two scenarios where this analysis would be incorrect. The first is that money managers operate under cartel-like industry structural conditions which would create greater price elasticity. I don't believe this is true. If it is true, there are other policy implications. The second possibility is that public fund fiduciaries are not financially sophisticated, and that they believe that fees should be driven by the after-tax income of managers rather than risk-adjusted expected returns. If we do live in a world where managers can dictate fees in a manner disconnected from higher expected investor returns, then arguably public funds will and do deserve to pay higher fees.

AFTER 6:00 P.M.

Chairman RANGEL. Thank you. The Chair would now like to recognize Jonathan Silver, Managing Director of Core Capital Partners. Thank you for your patience.

STATEMENT OF JONATHAN SILVER, MANAGING DIRECTOR, CORE CAPITAL PARTNERS

Mr. SILVER. My pleasure, Congressman. Thank you.

Mr. Chairman, Ranking Member McCrery and Members of the Committee, my name is Jonathan Silver. I am the founder of Core Capital Partners, a Washington, D.C. based venture capital fund with about $350 million under management.

Core is a Member of the National Venture Capital Association, and I am here today representing the 480 member firms which together comprise about 90 percent of all the venture capital under management in the United States.

Thank you for the opportunity to be part of today's discussion. As part of your analysis, we believe it is important to understand the unique and valuable contribution venture capital investment makes to America's long-term economic growth, why the venture community believes that the current capital gains tax treatment on a venture fund's carried interest is both correct and necessary, and how H.R. 2834, as drafted, could damage the entrepreneurial ecosystem in the United States.

Literally thousands of companies would not exist today were it not for the venture capital support they received early on. Federal Express, Starbuck's, Google, e-Bay, Genentech, Amgen, and countless other companies were all at one time just ideas that needed startup capital and guidance.

Last year, U.S. based venture capital companies accounted for more than 10.4 million jobs and generated over $2.3 trillion in revenue. This represents nearly one out of every ten private sector jobs and almost 18 percent of U.S. GDP.

What is particularly important is these are new jobs, and in fact, often new industries. It was venture capital that made the semiconductor industry possible. We also saw the commercial possibilities of the Internet before others, and we jump started the biotech industry.

Where will the next wave of new businesses come from? No one knows. That is why venture capitalists look for opportunities in all 50 states. It is why venture funds have backed Music Nation in New York City, Incept Biosystems in Ann Arbor, Michigan, Interface 21 in West Melbourne, Florida, Boston Power in Westborough, Massachusetts, and Click Forensics in San Antonio, Texas, as examples.

Simply put, these jobs did not exist before venture capitalists started these companies. This is organic job growth, not financial engineering. This is sweat equity on the part of the entrepreneur and his or her backers, all working to create something valuable out of nothing. No other asset class shares this distinction.

The economic importance of these new companies cannot be understated. They are a critical part of our National economic engine. Over the last 5 years, the employment growth rate of all U.S. based venture backed companies was more than two and a half times that of non-venture backed companies.

In many important ways, we work exactly like the founders and entrepreneurs we back. Our startup companies almost all begin with an entrepreneur and a VC agreeing on an idea. There is no strategic plan, no senior management team, no customers. There is just our collective belief that the initial idea can potentially be turned into a viable and profitable business.

The underlying technology is developed by the entrepreneur. We get involved in building out the company. The combination of their technical knowledge and our business knowledge is equally responsible for the company's success.

We see no cash returns until the company we build together goes public or is acquired. If we co-found the company, work equally hard, and make intellectual contributions of equal value, why should the founder's share of the sale of the company be treated as a capital gain and ours viewed as performance for service and ordinary income?

I believe it is important to understand that venture capitalists are not just financiers. Along with the entrepreneurs, we are really co-founders. Without our active ongoing involvement, many of these companies fail or fail to launch, and potentially important innovations remain in the garage, incubator or lab.

As you have heard from earlier witnesses, venture firms are generally structured as partnerships and usually receive the right to receive 20 percent of the cumulative net profits of a fund.

In order to be treated as a long-term capital gain, venture capital carried interest must satisfy many requirements. It cannot be guaranteed in any form.

If the venture capital fund loses money or just breaks even, we do not receive any carried interest. Carried interest must also be attributable to the sale of a capital asset that has been held for over a year, making the payment very different from the year end bonuses that look at performance during a single year rather than over the long term.

Carried interest must also be attributable to the sale, as an IPO or acquisition of a capital asset to a third party. This is what makes carried interest different from other performance based compensation, which takes money and value out of a company's coffers. This is also what makes carried interest different from a lawyer being paid on a contingency fee basis or from an author being paid royalty income for a book or sales. In those cases, the lawyer and the author did not give up a capital asset to someone else.

Many venture capitalists supply tremendous effort and skill in helping their companies grow and still never receive carried interest compensation, but it is the possibility of earning carried interest that is a primary incentive for the venture capitalists to commit to the risky task of starting and funding new companies, just as it is an important incentive to the entrepreneurs to start those companies.

H.R. 2834 as written would change the venture capital entrepreneur limited partner paradigm; specifically, there are several ways in which the bill could result in fewer U.S. companies receiving venture capital.

First, if the carried interest tax on the industry were doubled, our ability to take financial risk will shrink. Because we rely on

the profits from our successful investments to offset the losses on the companies that fail, an increase in the tax rate requires funds to generate more successful company exits; companies that are now fundable may no longer constitute an acceptable risk, and would cease to attract venture financing.

The net result is that venture funds will tend to favor later stage companies in order to reduce the effort, risk and time required to exit. Early stage companies will be harder to start and to fund, hurting the lifeblood of the entrepreneurial system.

Finally, you should expect that some venture capital activity will move offshore. Many countries are actively promoting venture capital activity through tax and regulatory friendly environments in order to compete directly with the United States. This is already happening.

A significant number of successful experienced venture funds have shifted their focus to new funds in China and India and are actively working there.

As you continue the examination of capital gains policy and partnership tax law, we urge you to recognize the immensely important contribution venture capital has made in promoting investment and generating both job creation and economic growth, and to consider the potential harm H.R. 2834 could inflict.

By acknowledging that venture capital plays a special role in the U.S. economy, you underscore our long national interest in promoting innovation and job creation, and you re-affirm the necessary and important role that risk taking has played throughout our history.

Thank you.

[The prepared statement of Mr. Silver follows:]

House of Representatives Committee on Ways and Means
September 6, 2007
"Hearing on Fair and Equitable Tax Policy for America's Working Families"

Testimony of:
Jonathan Silver, Founder and Managing Director
Core Capital Partners
Washington, D.C.

Introduction

Chairman Rangel, Ranking Member McCrery, and members of the committee, my name is Jonathan Silver and I am the founder of, and a Managing Director at Core Capital Partners, a Washington, DC-based venture capital firm with approximately $350 million under management. At Core, we identify promising new technologies, often in the telecommunications, security and software sectors, and work to turn those inventions into viable commercial businesses. Core is also a member of the National Venture Capital Association, and I am here today representing the 480 member firms which together comprise 90 percent of all the venture capital under management in the United States.

My professional background spans both the private and public sectors. In addition to my investment work, which includes a stint as a partner in what was once one of the country's leading hedge funds, I was an Executive Branch appointee in the first Clinton Administration. I served as senior policy advisor to both the Secretaries of Commerce and Interior and as an advisor to the Secretary of the Treasury. In this capacity, I have had a chance to work with several of you and with members of your staffs in crafting thoughtful, forward-looking tax policy. I am here today in much the same spirit.

I would like to thank the Committee for the opportunity to share with you the venture industry's thoughts on three key issues, specifically:

1) the unique and valuable contribution venture capital investment makes to America's long-term economic growth;

2) why we in the venture community believe that the current capital gains tax treatment on a venture fund's carried interest is both correct and necessary; and,

3) how HR 2834, as drafted, could damage the entrepreneurial ecosystem in the United States – a system that has been at the heart of our country's economic leadership for decades.

How Venture Investment Contributes to Long-Term Growth

Literally thousands of companies would not exist today were it not for the venture capital support they received early on. Federal Express, Staples, Outback Steakhouse and Starbucks are well known examples of traditional companies that were launched with venture backing. Cisco, Google, EBay, Yahoo and countless other technology companies were all, at one time, just ideas that needed start-up capital and guidance.

In the same vein, venture capital has been an important catalyst for innovation in the life sciences and a multitude of medical innovations would not have been possible without it. Genentech started with venture backing. So did Amgen and Medtronic. Over the last several decades, venture capitalists have partnered with scientists to build successful businesses and bring to market such drugs as Herceptin, an important part of our war on cancer and Intergilin, which significantly reduces blood clotting. Studies suggest that more than one out of three Americans will use a medical product or service generated by a venture- backed life sciences company.

According to the econometrics firm Global Insight, last year US based, venture-backed companies accounted for more than 10.4 million jobs and generated over $2.3 trillion in revenue. Nearly one out of every ten private sector jobs is at a company that was originally venture-backed. Almost 18% of US GDP comes from venture-backed companies.

What is particularly important is that these are NEW jobs and, in fact, often NEW industries. For example, while the original breakthroughs were made in government labs, corporate R &D facilities and universities, it was venture capital that made the semiconductor industry possible. We also saw the commercial possibilities of the Internet before anyone else and jump-started the biotech industry. Venture investors are constantly looking for the next "big thing" and these days, many of us are active in building alternative energy companies in what is sometimes called the "clean technology" industry, a sector which I'm sure we all agree will play a vital role in America's global competitiveness for years to come.

Where will the next important businesses come from? The truth is, no one knows and that's why venture capitalists look everywhere, and in all fifty states, for those opportunities. It's why venture funds have backed Music Nation in New York City and Incept Biosystems in Ann Arbor, Michigan, Interface21 in West Melbourne, Florida, Boston Power in Westborough, Massachusetts and Click Forensics in San Antonio, Texas. I have attached a list of more than 3700 companies that have been funded in your states by the venture capital community. (Attachment A) Companies in the state of California have been omitted due to the length of that list. Each of these, and any of the many other companies venture capitalists start, could prove to be the beginning of new businesses, new industries and new jobs.

The economic importance of these new companies cannot be understated. They are a critical part of our national economic engine. From 2003-2006, a period chosen to exclude the potential effects of the tech "bubble", the employment growth rate of all US-based, venture-backed companies was more than 2 ½ times more than that of non-venture backed companies. That is also part of the reason that many of your state economic development agencies are actively looking for ways to attract venture capital investment. They know that venture backed businesses generate jobs and taxes and have a significant positive spillover effect on the life of a community.

There are two essential points to make here. These are NEW jobs and these are GOOD jobs. That these are new jobs is clear. Simply put, these jobs did not exist before venture capitalists started these companies. But further, these jobs are often in industries that require new economy skills which will be viable and transferable for years to come. This is organic job growth; we do not use leverage; there is no financial engineering taking place in these start-ups. This is sweat equity on the part of the entrepreneur and his or her backers. We are all working to create something real and tangible and valuable out of nothing and that's the very best kind of economic growth. No other asset class shares this distinction.

Venture Capitalists Act as Company Founders

Perhaps it would be useful to spend just a moment explaining what venture capitalists actually do and how the venture business works. I believe it will become clear that we work in many important ways exactly like the founders and entrepreneurs we back and quite differently from financial managers in other asset classes.

Venture funds raise capital from institutional investors like pension funds, endowments, and foundations and to a lesser extent from individual investors. Our charge is to invest these funds in the most promising start-ups, with the understanding that we will work with these companies until they can go public, be acquired by a larger entity or, as is sometimes necessary, shut down.

These start-ups almost all begin the same way, with an entrepreneur and a VC agreeing on an idea. There is no strategic plan, or, at least, not much of one. There is no senior management team; there are no customers. There is just our collective belief that the initial idea can potentially be turned into a viable and profitable business.

When we launch a company, we are investing both time and money, just like the entrepreneur. We generally invest a small amount at first and we expect to continue to finance the company as it grows. We often require the company to meet business-related

milestones in order to receive additional rounds of financing. For an early-stage company, five or six rounds of financing is not unusual. Our investment in each company typically lasts 7-10 years, often more and rarely less. We see no cash returns until the company goes public or is acquired. Even at that point in the life cycle, venture capitalists are not paid from company dollars but by outside parties establishing a fair market value.

We also invest our time and lots of it. We take a seat on the board and work with the management team, often on a daily basis, developing strategy, introducing the company to customers and suppliers, identifying and hiring key managers, and leveraging our past experience to address competitive and operating issues.

Let me give you a sense of scale. At Core, over the life of a fund, we expect to make somewhere between 20-25 investments. We have five partners. A fund's initial investment period usually lasts about five years. So, our partners make 1-2 investments a year per partner. We do not have hundreds of positions in the portfolio and we couldn't, because we don't invest in stocks, we start companies.

We are often as actively involved as the founder. Very frequently, the initial idea for a company is developed by a professor or a research scientist who does not want to leave his or her current position. They may be involved a day or two a week, lending technical guidance to the new company. We get involved in building out the company. The combination of their technical knowledge and our business knowledge is equally responsible for the company's success. If we co-founded the company, work equally hard, make intellectual contributions of equal value, why should the founder's share on the sale of the company be treated as a capital gain and ours viewed as performance for service and ordinary income?

I believe it is important to understand that venture capitalists and entrepreneurs are really co-founders, we are not just financiers. Without our active, ongoing involvement, many of these companies fail, or fail to launch, and potentially important innovations remain in

the garage, incubator or lab. For their contribution, entrepreneurs receive founders stock, which, if sold, is taxed at the capital gains rate. Venture capitalists, for our contribution, receive carried interest, which is also taxed at the capital gains rate, but only to the extent attributable to the value created by the sales of our companies. This arrangement creates an equilibrium of incentives for all the key players.

Venture Capital is a Long Term and High Risk Investment in Value Building

Venture capitalists embrace patient, long-term, high-risk investment to create a valuable asset – a company. As I noted, the life of a venture capital investment in a company is 7-10 years and life sciences companies typically remain in a portfolio for 10 – 15 years. We do not "flip" companies by buying or selling them quickly. There is nothing to "flip." We remain invested in a company over multiple rounds for multiple years. Every single dollar of venture capital investment goes toward company growth. We typically do not use leverage, charge the company any fees, or pull dividends from the company during our involvement.

A venture capital fund is not liquid. Investors, including the venture capitalists themselves, must be prepared to have their investments committed for the life of the fund. The long-term commitment is especially significant given the high risk nature of our business. It is estimated that approximately 40 percent of all venture backed companies fail; 40 percent make only modest returns; only 20 percent of companies achieve realizable gains. It is this last 20 percent which venture capitalists rely on to cover all the other losses and generate returns to the fund.

Venture Capital Remains a Relatively Small, Cottage Industry

Despite the value that has been created by venture capital investment, our asset class remains a very small component of the alternative investment sphere. To give you some perspective, venture capital investment in 2006 represented only 0.2% of US GDP. In 2006, the venture capital industry raised only one quarter of what the buyout industry

raised. Thus far in 2007 buyouts are outraising venture capital by a ratio of 8:1. We manage 15 percent of what the hedge fund industry manages. There are less than 800 active venture capital firms in the United States, and that number has been declining for the last 5 years. The notion that venture capital has grown exponentially as an asset class is factually incorrect.

Venture Capital and Carried Interest

Now that I have explained what we do, I would like to share with you how we are compensated. For our contribution, the venture capital firm typically receives two types of income – a 2 percent annual management fee and a 20 percent share of the VC fund's cumulative net profits. This 20 percent entrepreneurial profit share is typically referred to as the "carried interest." The management fee is guaranteed and taxed at an ordinary income rate; the carried interest is entirely contingent upon a profitable fund and is taxed based on the type of income earned by that fund. So, to the extent the fund sells companies, the carried interest is taxed at the capital gains rate.

In order to be treated as a long-term capital gain, carried interest must satisfy many requirements. It is contingent upon the profits of the venture capital fund and cannot be guaranteed in any form. Unlike most compensation income, if the venture capital fund loses money or just breaks even, we do not receive any carried interest. Carried interest also must be attributable to companies that have been held for over one year making the payment different from end-of-year bonuses that look at performance during a single year, rather than over a long-term period. Carried interest also must be attributable to the sale (either IPO or acquisition) of a capital asset to a third party. This is what makes carried interest different from other performance-based compensation that takes money and value out of the company's coffers, rather than leaving the value in the company and being "paid" by a third party. This is also what makes carried interest different from a lawyer being paid on a contingency fee basis or from an author being paid royalty income for his or her book sales. In those cases, the lawyer and author did not give up a capital asset to someone else.

Venture capitalists have openly used this same structure for the last 30 years. We pay ordinary income tax on the guaranteed portion of our compensation that is not contingent upon building value. We do not employ creative tax structures. We do not use offshore accounts or deferred income structures to avoid paying taxes.

Like our investments, the carried interest which we receive is also long term and high risk. It is not paid out every year. It is certainly not a guaranteed "pay for performance" bonus. In fact, many venture capitalists can apply tremendous effort and skill in helping their companies grow and still never receive carried interest compensation. Here is why: unlike a bonus that is earned each year by an employee at an investment bank or other financial services corporations, carried interest in the venture capital context will only begin to be paid out if institutional investors are made whole on their *entire* investment in the venture capital fund, including in most cases their re-payment of all their management fees. This is a very large, multi-million dollar hurdle for a fund to achieve. Therefore, we typically do not receive distributions of carried interest on the IPO or sale of a single company. The returns of a single company are not typically enough to make the limited partners whole. Instead, it takes almost the entire fund life to see "how the story will end" so it is often not until year 7 or 8 that the possibility of carried interest is even available. But it is this possibility of earning carried interest that is the primary incentive for venture capitalists to stay in the game – and work to grow our companies to the best of our abilities for the full ten years or longer. In this regard our interests are perfectly aligned with both the limited partners (who want us working the portfolio until the last company exits) and the entrepreneurs (who also want us as a founding partner until a successful outcome). Carried interest, and the favorable capital gains tax treatment that is currently applied to it, is our incentive to invest our time into these high risk companies for the long term.

The Venture Capital Partnership is Aligned

For the last thirty years, the limited partner community has understood our contribution to founding companies very well. Their understanding is reflected in our partnership agreements which grant us 20 percent of the funds' profits in exchange for our sweat equity. We are only successful if the fund is successful. It is not unlike a partnership in which two individuals come together to open a store. Person A has the capital; Person B has the time and knowledge to run the store and grow the business. If the store is successful and is ultimately sold, that partnership has determined on its own that Person A is entitled to 80 percent of the profits; Person B is entitled to 20 percent. Both pay tax at capital gains rates because that is the fair treatment of each individual's contribution under current partnership and tax law. The venture capital scenario is no different.

HR 2834 suggests that capital gains tax treatment should only be offered for the *financial* capital the individual invests. While venture capitalists do indeed invest their own money alongside of the limited partners and entrepreneurs, most venture capitalists do not have the personal wealth to fund the number of companies necessary to operate a fund on their own. Under the proposed law, venture capitalists would lose the majority of their tax incentive to operate as we do today, offering our sweat equity and intangibles in exchange for what is, in essence, founder's stock. If Congress passes HR 2834 without amendment, you will be sending a strong message to the US venture capital community which says you do not believe that what we do creates value.

HR 2834 Will Hurt Venture Capital and the US economy

HR 2834, if passed as currently written, will fundamentally change the venture capital business. I cannot tell you what the exact nature and form that change will take, but we do know that HR 2834 would dramatically change the venture capital-entrepreneur-limited partner paradigm, and such transformations do not happen without repercussions. In 1979 the Department of Labor's Prudent Man rule allowed pension funds to invest in our asset class, and that change had a profound and positive effect on investment and

innovation. Our fear is that HR 2834 will have the opposite effect, chilling venture investment, and thereby unintentionally causing harm to the US economy. It will not happen immediately and there will be no giant implosion. By the time the damage is felt, however, it will be too late. Specifically, there are three ways in which the bill is likely to result in fewer US companies receiving venture capital.

First, if the carried interest tax on the industry were doubled, our ability to take financial risk would shrink. Because we rely on the profits from our successful investments to outweigh the losses on the companies that fail, an increase in the tax rate requires funds to generate more successful company exits to make themselves whole. Where today we can remain in business if only 20 percent of our companies provide meaningful returns, we will now need 25 or 30 percent of our companies to perform well to make up for the additional taxes. This requirement will necessarily factor into our investment decision-making, and particularly with respect to any investment that could result in a total loss. Companies that are now within the range of acceptable risk may no longer meet this threshold and may cease to receive venture financing. The net result is that venture firms will tend to favor later-stage companies in order to reduce the effort, the risk, and the time required to exit. Early-stage companies would be harder to form and fund, reducing the overall number of venture backed companies and hurting the life blood of the entrepreneurial ecosystem. If venture capitalists do not fund these risky companies, no one will.

Second, a doubling of the carried interest tax rate will, almost certainly, affect our ability to attract talented professionals to the industry. Venture capitalists possess a unique skill set – technological expertise and business acumen. These skills are in high demand and there is competition for these individuals, who are well positioned to follow other career paths. It is the promise of carried interest that allows venture capital to compete with other careers from a financial perspective. However, the long delay before any potential carried interest is ever paid requires significant confidence and foresight in any professional. Taxation as an owner of the businesses those professionals build (i.e., as capital gain) has enabled those of us who are partners in venture funds to continue to

attract junior talent. If this factor is eliminated, it will be one more reason for these professionals to seek more consistently lucrative positions in less high-risk and less innovative industries. The number of venture capital professionals and firms has declined in each of the last 5 years. We are reaching a dangerous tipping point in which we do not have enough professionals coming in to the industry to enable the industry to make capital available to companies which need it most…and I should point out that it is only reasonable to assume that states like Michigan, Pennsylvania, Florida and Ohio, with great young companies but few venture capitalists will be hit first and hardest.

Finally, and with an eye to our global competitiveness, the taxation of carried interest has an impact on the capital that is deployed by venture capital firms in the US, as young venture capitalists entering (or moving within) the industry might favor non-US firms if US tax laws become less accommodating. It is true that US tax rules might prevent US citizens from such a behavioral response. There are, however, many non-US venture capitalists who currently operate in the US, but who could easily move their activities back to their home countries. Many of those countries, like Israel, India and China, are actively pursuing venture capital activity through tax- and regulatory-friendly environments in order to compete with the US in the innovation- and knowledge-based economy. Similarly, firms with multi-national teams and multi-national strategies could shift more capital to their non-US activities. This global shift in venture investing is already happening. A significant number of successful, experienced American venture capitalists are shifting their focus to new funds in China and India where they are apprenticing new, local venture capitalists and forming companies and jobs. In 2006, US venture capitalists invested over $3.4 billion dollars in Asian companies, doubling the funds invested in 2004. The year 2007 is on track to surpass this number with ease. This movement overseas has happened over a very short period of time demonstrating that money and human capital does respond quickly to market incentives.

Conclusion

Congress always faces difficult choices as it reviews tax policy at large, and the discussion around capital gains tax policy clearly generates strong views from Members on both sides of the aisle. As you continue the current examination of the intersection of capital gains policy and partnership tax law, we urge you to recognize the immensely important and positive impact that our current tax treatment has had in promoting investment and economic growth. We also urge you to consider the potential harm HR 2834 could inflict on the fragile entrepreneurial ecosystem if applied to venture capital. By acknowledging that venture capital plays a special role in the US economy, you will be standing up for company creation, for new jobs, and for innovation. You will be standing up for your individual states where a successful venture backed company can create a thriving regional economy just as Dell did for Austin or Medtronic for Minneapolis. And you will be affirming that Congress understands that capital gains tax treatment for venture capital investment should continue because, as an asset class, we create long-term, measurable, risk-based, and undisputed value for the US economy.

I thank you for your time.

Chairman RANGEL. Thank you.

Next is Adam Ifshin, President of DLC Management Corporation in my hometown in New York, Tarrytown. Thank you.

STATEMENT OF ADAM IFSHIN, PRESIDENT, DLC MANAGEMENT CORPORATION

Mr. IFSHIN. Thank you, Chairman Rangel, Ranking Member McCrery, Members of the Committee. My name is Adam Ifshin and I am the co-founder and President of DLC Management Corporation, an owner, developer and redeveloper of shopping centers headquartered in Tarrytown, New York.

DLC specializes in revitalizing older shopping centers in first tier suburbs, cities, and some small towns.

I am appearing today on behalf of the 70,000 members of the International Council of Shopping Centers, the Real Estate Roundtable, and other real estate organizations whose members will be significantly impacted by proposals to tax the return on all carried interest as ordinary income.

We understand and appreciate that H.R. 2834 is intended to improve tax fairness and the income disparity gap. However, we believe that H.R. 2834 is not the proper tax policy for real estate and would not accomplish these goals.

We believe the legislation would hinder real estate entrepreneurs at all levels and particularly those in earlier phases of building their businesses.

Therefore, we urge Committee Members to proceed very cautiously, as the real estate industry and the communities it serves across the country have much at stake.

While current law is far from perfect, we believe that H.R. 2834 would result in the most sweeping and potentially most significant tax increase on real estate since the retroactive application of the passive loss rules in 1986.

I started DLC when I was 26 years old. Since starting with nothing, my company has grown to become one of the nation's preeminent owners and mid-sized operators of retail shopping centers, with 72 such assets in 25 states.

Over the past 16 years, my firm has focused on rejuvenating under served markets by investing hundreds of millions of dollars in commercial real estate. DLC is dedicated to creating value, primarily through the redevelopment of older distressed properties in challenging environments, which often include older suburbs and cities, such as Peekskill, New York, properties like Levittown Mall in Tullytown, Pennsylvania, and underserved rural and multiethnic city neighborhoods in Carbondale, Illinois and inner city Baltimore, Maryland.

We re-invest most of our capital gains into new projects to make long-term investments in communities that may not otherwise see revitalization. I can unequivocally state that my company as it exists today could not have been built if the taxation on gains was at the ordinary income rates proposed by H.R. 2834. The returns simply would not have justified the risks.

The carried interest is the return on the entrepreneurial risk that makes a project happen. Embedded in my business plan and virtually every other real estate partnership over the last several

decades, is the concept that a material component of the general partner's compensation will be capital gain.

Of course, that assumes there is long-term appreciation that results in a capital gain. Many real estate developments never get off the ground, still others fail or fall short of their goals. In these cases, the general partner gets nothing and frequently loses money. Most real estate projects take 5 to 10 years to fully mature from concept to stabilization. This long-term investment is risky and the returns have to justify that risk.

If H.R. 2834 were to be enacted, returns would go down as the tax burden goes up. Some development would certainly still occur, but the material shift in the risk/reward tradeoff for the developer/operator would mean that fewer projects would be built. Those that would be built would tend to be high end developments in wealthy communities and central business districts where there tends to be less risk.

What H.R. 2834 proposes for real estate makes under served and given up for dead locations far less appealing to developers. Those projects are harder to put together and generally entail much greater risks. The net result will be to cause the greatest harm to those communities that need development and revitalization the most, communities where we have done work, like Newburg, New York, Spring Valley, New York, and the west side of Baltimore City, where there is a fundamental lack of shopping alternatives for predominately minority consumers.

A lack of retail options leads to higher prices for basic commodities like milk and bread for those people who can least afford to pay.

In the context of real estate, H.R. 2834 is based on a flawed premise, the notion that a carried interest is a proxy for a fee, particularly a fee for investor money management. The real estate general partner is a manager and developer of an asset, not a money manager.

Properties require intensive work. You cannot just buy them and do nothing and sell them years later. A carried interest is not granted for typically routine services like leasing and property management, but for the value the general partner will create beyond routine services. It is granted for bringing the deal.

It is for committing to the venture alongside the investors in something that will be highly illiquid. It is granted because the general partner is subordinating his return to that of his limited partners.

The carried interest is also granted in recognition of the risk exposure that a general partner has in a venture. Typically, a general partner is responsible for all partnership liabilities such as environmental contamination, lawsuits, and often explicit guarantees, matters such as construction completion, operating deficits, and a mortgage on those properties.

In the case of development, a carried interest recognizes development risks and opportunity costs borne by the real estate entrepreneur, both before and after the admission of the financial partner.

Bottom line, we are asset managers of hard assets, not money managers.

In conclusion, almost one-half of all partnership tax returns are filed by real estate entrepreneurs. Over $1 trillion in equity is invested in real estate through partnerships leveraged on another 30 to 40 percent.

At the end of the day, this is not a Wall Street issue; it is a Main Street issue. At stake are job creation, economic development, and revitalization of communities across the country.

Thank you for holding this hearing and for giving me the opportunity to testify. I welcome all of your questions.

[The prepared statement of Mr. Ifshin follows:]

Prepared Statement of Adam Ifshin, President, DLC Management Corp., Tarrytown, New York

Thank you, Chairman Rangel and Ranking Member McCrery for conducting today's hearing on potential changes to the tax treatment of partnership "carried interest."

My name is Adam Ifshin and I am the incoming chairman of the International Council of Shopping Centers' economic policy committee and the co-founder and president of DLC Management Corporation, an owner, developer, and re-developer of shopping centers, headquartered in Tarrytown, NY. DLC specializes in revitalizing older properties in in-fill first tier suburbs, cities and some small towns.

I am appearing today on behalf of the ICSC, the Real Estate Roundtable, and other real estate organizations listed whose members will be significantly impacted by proposals to tax all carried interest as ordinary income.

We understand and appreciate that H.R. 2834 is intended to improve tax fairness and the income disparity gap. These are issues that warrant serious attention. However, we believe that H.R 2834 is not the proper tax policy for real estate and would not accomplish these goals. We believe the legislation would hinder real estate entrepreneurs at all levels and particularly those in the earlier phases of building their businesses.

Therefore, we urge Committee Members to proceed very cautiously, as the real estate industry and the communities it serves across the country have much at stake. While current law is far from perfect, we believe H.R. 2834 would result in the most sweeping and potentially most significant tax increase on real estate owners since the enactment of the passive loss rules of the 1986 Tax Reform Act. The application of those rules, particularly to existing real estate investments, triggered unintended consequences, namely the savings and loan collapse, a credit crunch that caused a major downturn in the real estate industry and cost taxpayers billions of dollars. H.R. 2834's effect on entrepreneurial risk taking—especially of those whose efforts most directly impact Main Street—would cause unintended consequences that would ripple through the economy.

History of DLC Management

I started DLC Management when I was twenty-six years old. The commercial real estate industry was struggling to overcome the damage caused by the savings and loan crisis and the 1986 Tax Reform Act. Since starting from the ground floor, my company has grown to become one of the nation's preeminent owners and medium-size operators of retail shopping centers with 72 centers located across 25 states. Over the past 16 years, DLC has created value in underserved markets by investing hundreds of millions of dollars in commercial real estate. DLC focuses on the redevelopment of older distressed properties in challenging environments, which often include older in-fill suburbs and cities such as Peekskill, NY, environmentally challenged brownfield properties like Levittown Mall in Tullytown, PA, and underserved rural or multi-ethnic city neighborhoods like Carbondale, IL, and inner city Baltimore, MD.

We reinvest most of our capital gains into new projects in order to continue to make long-term investments in communities that might not otherwise see revitalization. And I can unequivocally state that my company as it exists today could not have been built if the taxation on gains was at the ordinary income rates proposed by H.R. 2834. The returns simply would not have justified the risk in many cases.

Discussion of the Carried Interest Structure

A carried interest is the return on the entrepreneurial risk that makes the deal or project happen. Embedded in the DLC business plan, and virtually every real estate partnership of the last several decades, is the concept that a material compo-

nent of the compensation to the general partner is capital gain. Of course, that assumes there is a capital gain in the end. Many real estate developments never get off the ground. Still others fail or fall short of their goals. In all these cases, the general partner gets nothing other than fees.

For years, many real estate transactions have been structured as limited partnerships. In a typical limited partnership, there will be one or more financial investors as the limited partners and an operator or developer, serving as the general partner. The general partner brings a combination of intangible assets, assumption of significant risk, and intellectual capital as part of arranging and operating the venture. In exchange, the general partner receives a share of future partnership profits, typically after the limited partners receive a minimum compounded preferred return generally in the range of 8–12 percent per annum and their initial equity back. The general partner's profits are a pre-determined percentage of the residual profits that is arrived at after the limited partners have attained their required minimum return on the investment.

In addition to this subordinated carried interest, the general partner typically has two other economic interests in the partnership. The general partner or a related entity receives a non-profit based management fee for performing day-to-day property management services. This is taxed as ordinary income. The general partner typically also invests capital, side by side with the investor, commonly 1–10 percent of the total capital in the partnership. This is structured as a limited partner interest.

What the Carried Interest Represents to the General Partner and Investors

The industry has long favored this carried interest format because it pairs the experience and early stage risk-taking of the real estate developer/businessperson with the capital of the financial partner in a flexible structure that best matches risks and rewards for both parties. Moreover, it has survived five decades of tax legislation including numerous overhauls of the Federal tax law relating to both partnerships and real estate.

In the context of real estate, H.R. 2834 is based on a flawed premise—the notion that a carried interest is a proxy for a fee—specifically a fee for investor money management services. The real estate general partner is a manager of an asset. Buildings require an intensive amount of owner attention. You cannot just buy them and do nothing until you sell years later. They require substantial amounts of capital and management from development or acquisition through disposition to be productive assets.

Why do the limited partners grant the general partner a carried interest? A carried interest is granted not for routine services like leasing and property management, but for the value it will add to the venture *beyond* routine services. It is granted for the general partner bringing the investors the "deal." It's for committing to a venture alongside the investors that will be highly illiquid. It is granted because the general partner is subordinating his return to that of the limited partners. It is for the general partner's business acumen, experience and relationships. Knowing when to buy, how much to pay, whether to expand or renovate, when to sell and to whom. This is the "capital" the general partner invests in the partnership.

The carried interest is also granted in recognition of the risk exposure the general partner has in the venture. This exposure is often far greater than the money it contributed. Typically, a general partner is responsible for all partnership liabilities such as environmental contamination and lawsuits, and often explicitly guarantees matters such as construction completion, operating deficits and debt. In the case of development, a carried interest recognizes development risks and opportunity costs borne by the real estate entrepreneur, both before and after admission of the financial partner.

Primary among these risks is the risk that governmental approvals will not be obtained or, even if obtained, will not be timely or achieved within budget. Besides zoning and development plan approvals, such approvals include specialized permits such as those for wetlands, sewer, and roadway-related matters. Approvals typically take years and can cost hundreds of thousands, even millions of dollars, for a single project. They represent a unique risk of the developer because financial partners normally will not commit until all or most of such approvals are obtained.

After the financial partner is admitted, the developer bears risks disproportionate to its capital contributions because at a minimum it alone guarantees that the building will be completed on time and within budget. It takes considerable business acumen, experience and skill to manage major building construction. Design changes, tenant change orders, labor or material cost increases and schedule delays must be managed against pre-determined budget and reserve amounts, or the general partner will be left responsible for cost overruns.

Acquisition of existing properties also presents some of these same development risks although on a lesser scale. Most acquisitions of existing buildings are made with the plan to put additional capital into building improvements. This is because many buildings are sold with deferred maintenance obligations or at a time in the ownership cycle when new capital infusion is needed to keep the building updated and optimally marketable. These improvements may be in the form of expansion or renovation of varying scale. The amount of capital added will depend on the age and condition of the building, market demand and what amount and type of investment the owners believe will maximize the return on investment. Again, the general partner must manage this capital investment wisely or bear the risk of cost overages.

Development and property management services are explicitly compensated through fees negotiated at arm's length between the real estate entrepreneur and the financial partner. As in other markets, such negotiations are driven by industry practice and the size of the project. Beyond the discipline of market forces in setting such fees, the "disguised fee" rules of Section 707 of the Internal Revenue Code have since 1984 precluded using partnership distributions as a proxy for fees to the developer (or any other partner). Thus a developer's carried interest represents not compensation for services but recognition of the considerable development risk taken, the substantial opportunity cost involved in pursuing a particular project and putting one's balance sheet at risk to it, and the value added to the venture from directly aligning the interests of the developer and the financial partner. The general partner also can be at risk for recourse loans and environmental indemnities for all loans.

H.R. 2834 Discriminates Against Partnership Form—Founders Stock Analogy

H.R. 2834 discriminates against the partnership form. Under the bill, if an entrepreneur managed a partnership venture and received a carried interest, the return paid on the carried interest would be ordinary income. However, if instead of taking in a capital partner, he is able to borrow the capital from a bank and operates as a sole proprietor, capital gain treatment would be allowed on the carried interest return. The entrepreneur is conducting the same activity in both scenarios yet the bill would result in different tax treatment.

The corollary in the corporate world is seen in companies such as Google and Microsoft where the founders took the earliest (and greatest) risk in launching the enterprise and were later joined by financial partners who purchase preferred stock for a much larger capital contribution per share than that made by the founders. Neither Congress nor Treasury questions the wisdom or fairness of affording capital gains treatment to such founders when they ultimately sell their stock. The same logic should apply to a partnership between the "founder" of a real estate project and its subsequent financial backer.

H.R. 2834 Would Encourage Use of Debt over Equity

H.R. 2834 would have the effect of favoring debt over equity. Partnerships with equity contributions would be subject to the bill's tax increase while loan arrangements would not. So, taxpayers would be encouraged to structure a transaction as a loan from the investor to the entrepreneur instead of forming a partnership with the investors making an equity contribution. Encouraging debt over equity is not good policy generally and certainly is not good policy in the current credit and liquidity climate. The world financial markets have been roiled by their exposure to an abundance (perhaps overabundance) of lending from subprime mortgages to commercial conduit financing. Mortgage backed securities are suffering steep declines in values. We will soon see how strong or fragile these markets are. Nevertheless, this does not appear the time to impose a tax that would affect the value of the real estate collateralizing a significant portion of the debt market.

DLC Achievements Using the Carried Interest

Following are some illustrations of DLC's achievements of bringing national retailers and new life into towns and properties time long forgot—these deals were all done in a partnership format with carried interest taxed at the capital gains rate. If current law is changed to tax carried interest at the ordinary income rate, then the investment viability of projects like these could be brought into question—and eventually a disruption in the real estate marketplace could take place.

- Spring Valley, NY—DLC brought Target, Bed, Bath and Beyond, Michaels Arts and Crafts, T.J. Maxx, 9 West and other recognized retailers to a 70 percent vacant center in a market that is 50 percent African-American and 30 percent Latino. Most of the retail had moved out to an upscale mall three miles away, yet through our efforts, the center is now 100 percent occupied. During this project, 550 construction jobs were created; 650 retail jobs added. DLC paid over

$30 million for the center and has spent $12 million in investments, the largest private sector investment in Spring Valley in the past 20 years.

- Peekskill, NY—DLC totally re-developed a 1950's shopping center where the supermarket anchor and the junior anchor had both gone bankrupt. We brought the first new full service grocery store, a Stop & Shop, to this predominantly minority community in 20 years. Other national tenants include a CVS, Dunkin' Donuts, Dollar Tree and Tuesday Morning. The project produced 600 new construction jobs and 400–450 permanent retail jobs. Our development was 100 percent privately funded and over four years in the making. DLC paid $14 million for the site and invested $19 million thereafter to redevelop it.
- Oxon Hill, MD—DLC acquired two underperforming grocery anchored shopping centers in an African-American community. We fully expanded and renovated one center and brought to 100 percent occupancy, featuring retailers such as Shoppers Food Warehouse, A.J. Wright and Advanced Auto. The rejuvenation of the second center is now underway with new facades, new national tenants and the Giant grocer is renovating and expanding.
- Levittown, PA—DLC tore down an obsolete 1950's open air mall. This project required major environmental brownfields remediation to address more than one million square feet of asbestos-containing material and 67 underground fuel tanks. Now there is a new center being built featuring a Home Depot, Wal-Mart Supercenter, Ross Dress for Less, Starbucks, Wachovia, Famous Footwear, Dress Barn, Day Care Center and others. Over 1,000 construction jobs have been created and 1,000 retail jobs. DLC bought the property for $9.5 million and will invest $60 million total, without any public subsidy. This center will be the largest commercial taxpayer in the borough.

Impact of H.R. 2834 on Real Estate

Most real estate projects are not short term in nature. Projects frequently take 5–10 years to fully mature from concept to entitlements, to construction, to lease up, and stabilization. If H.R. 2834 were to pass the Congress some development would still occur, but the material shift in the risk/reward trade-off for the developer would mean that fewer projects would be built. Those that would be built would tend to be higher-end, fancier developments in wealthy communities and central business districts where there is less risk.

What H.R. 2834 proposes makes underserved and given-up-for-dead locations, like those described above, far less appealing to developers because those deals are harder to put together and have greater risk associated with doing them. The net result will be to cause the greatest harm to those communities that need development and revitalization the most—communities like Newburgh, NY, Spring Valley, NY, and the West Side of Baltimore, where there is a fundamental lack of shopping alternatives for predominantly minority consumers. A lack of retail options leads to higher prices for basic commodities like milk and bread for those people who can least afford to pay.

Community leaders where we do business fully understand and appreciate the benefits our development brings to their citizens—more consumer choices at less cost, job opportunities, both at the construction phase and thereafter, an increased tax base and improved quality of life.

I should add at this point that while my business is in the retail shopping sector, the use and importance of the carried interest is the same for all types of real estate—apartments, office and industrial. Examples of retail projects I've cited in this testimony could just as easily be affordable apartment complexes or mixed-use projects that combine residential, retail and office elements. The same entrepreneurial risk is involved, similar investment duration and similar subordination of the general partner's return to the investors' return.

Effect on Tax Fairness and Income Disparity

Finally, it is often mentioned that H.R. 2834 is a matter of tax fairness. The question is rhetorically asked, "Why should a wealthy Wall Street investment manager be allowed to pay at tax at a rate less than his or her assistant?" I acknowledge that there are significant issues of tax fairness in the Tax Code and income disparity in the country and the industry applauds Congress for addressing these issues. However, I don't think the analogy is as simple or as accurate as it first sounds. First, an executive assistant's effective tax rate is not likely to be 35 percent. Because of the progressivity in our tax system and the variety of exemptions or deductions that exist, it's likely the assistant's effective tax rate is substantially less than 35 percent. Nevertheless, and more importantly, we don't believe H.R. 2834 would be an effective tool in addressing these issues and, in fact, would have a counterproductive effect.

The most successful real estate managers, whether they are in real estate or other industries, would be able to pass the increased tax cost onto investors. These investors would have to accept this cost shifting (at least most of it) if they want their capital invested by the most successful real estate owner/operators. Alternatively, these real estate managers will be able to use their resources to re-structure their transactions to avoid the tax altogether.

Those entrepreneurs that are trying to develop their business and are scraping and competing for capital, will not have the negotiating leverage to pass on the increased tax to their investors. Neither would many have the resources to re-structure transactions from the long accepted partnership/carried interest structure. As a result, it is the entrepreneurs at this end of the entrepreneurial spectrum that most likely will bear the brunt of H.R. 2834's proposed tax increase. That outcome will not promote tax fairness or mitigate income disparity.

H.R. 2834 would result in tax favored capital gain treatment being limited to those taxpayers that have the money to invest in real estate. Those that don't have the money to invest, but are willing to take risk and invest sweat equity, would not be allowed favored tax treatment. Current law allows a more balanced result and I encourage Members of the Committee to consider this carefully as they move ahead.

Effective Date

H.R. 2834 does not have an effective date. As the passive loss rules demonstrated 20 years ago, applying tax increases to existing investment partnerships is effectively retroactive application. The resulting disruption could be as dramatic as we saw in 1986. The passive loss rules helped trigger the savings and loan crises and billions of dollars in lost real estate value. Therefore, any modification to the carried interest rules as they apply to real estate should apply only to partnerships entered into on a going forward basis and not existing partnerships.

Conclusion

According to IRS statistics, in 2005, 46 percent of partnership tax returns came from the real estate industry. Over $1 trillion in equity is invested in real estate through partnerships leveraged on average another $300–$400 billion in loans. Therefore, a major change in partnership tax rules, such as that proposed by H.R. 2834, would have a tremendous impact to the real estate industry—a significant economic driver in our nation's economy. At the end of the day, this is not a Wall Street issue—it's a Main Street issue. At stake are job creation, economic development, and revitalization of communities across the country.

Chairman Rangel and Ranking Member McCrery, thank you for holding this hearing and for giving me the opportunity to testify. We look forward to working with you as you continue to examine this matter.

Real Estate Trade Association Members of The Real Estate Roundtable:
National Association of Real Estate Investment Trusts
National Association of Realtors
National Association of Homebuilders
National Association of Real Estate Investment Managers
National Multi-Housing Council
National Association of Industrial and Office Properties
Pension Real Estate Association
Mortgage Bankers Association of America
International Council of Shopping Centers
Commercial Mortgage Securities Association
Building Owners and Managers Association International American Hotel & Lodging Association
American Resort Development Association
Association of Foreign Investors in Real Estate
Urban Land Institute

APPENDIX A

FACTS ABOUT THE REAL ESTATE INDUSTRY

The following facts illustrate the overall contribution real estate makes to communities and the economy:

- Real estate is a vital part of our national economy contributing, over $2.9 trillion or one third of the Gross Domestic Product. Real estate asset values, residential and commercial, total nearly $20 trillion. Real estate creates jobs for over 9 million Americans—and these are not "off-shored."
- America's real estate is the source for nearly 70 percent of local tax revenues, which pay for schools, roads, police and other essential public services.

- U.S. commercial real estate is worth approximately $5 trillion.
- Private investments in commercial real estate done largely through partnerships have a total equity of over $1 trillion.
- America's 50,000 shopping centers account for over $2.25 trillion in sales and generate over $120 billion in state sales taxes.
- Multifamily construction starts in 2006 totaled 338,000 housing units for a total of $50 billion of housing investment. Housing services for rental apartments totaled $263 billion in 2005.
- Housing accounts for 32 percent of household wealth. Total single-family (owner occupied) housing is worth approximately $15 trillion, with homeowners' equity valued at around $8 trillion.
- Publicly traded real estate investment trusts (REITs) have a total equity market capitalization of $355 billion.
- Real estate partnerships make up the second largest share of partnerships, measured in total assets, but represent the largest share of both partnerships (1.2 million) and partners (6.6 million people).
- Real estate partnerships are responsible for investing $2.6 trillion in assets. 59.9 percent of their income comes from long-term capital gains; 40.1 percent is taxed at ordinary income tax rates.

Chairman RANGEL. The Chair recognizes the testimony of Bruce Rosenblum, Managing Director of the well known Carlyle Group and Chairman of the Board of Private Equity Council.

STATEMENT OF BRUCE ROSENBLUM, MANAGING DIRECTOR, THE CARLYLE GROUP, AND CHAIRMAN OF THE BOARD, PRIVATE EQUITY COUNCIL

Mr. ROSENBLUM. Thank you, Chairman Rangel, Ranking Member McCrery, and Members of the Committee.

I am pleased to appear before you today on behalf of the Private Equity Council to present our views on the taxation of carried interest for partnerships.

First, a few points about the private equity industry. It is not just large firms like Carlyle. It includes hundreds of firms, large and small, located in all parts of the United States. Even the largest firms today were small businesses as recently as 15 or 20 years ago, and they are still owned in significant part by their founders.

Over the years, numerous companies, including household names such as Auto Zone, J–Crew and Dunkin Donuts, have been turned around or improved by the focused strategies that characterize private equity investment, and private equity has been extremely profitable for its limited partner investors, comprised in significant part of pension funds, universities and foundations.

Private equity activity is driven by firms known as sponsors that establish private equity partnerships or funds. The sponsor serves as the general partner of the fund, sets the fund's strategy and makes the initial capital commitment to the fund.

The sponsor raises additional capital from third party limited partners, and the respective ownership rights of the sponsor and these limited partners are established at the inception of the fund.

Typically, the sponsor's ownership rights include a so-called carried interest. Partnership structures using carried interest are pervasive across many business sectors, not only in private equity and venture capital partnerships, but also in real estate, timber, oil and gas, small business, and family partnerships. They have been used for many years and their tax treatment is well settled.

Equally well settled are the principles defining capital gains, and it could not be more clear that private equity activity is at the core of the capital gains definition: owning and growing the value of businesses.

While private equity firms also receive many types of income that are not capital gains, such as fees, rents and interest, it can hardly be disputed that the profits from the sale of a business that is owned and improved over many years is a capital gain.

What are the arguments in favor of changing this well settled tax treatment? The ones I have heard rest on fundamental misunderstandings about private equity ownership and the nature of capital gains.

For example, the premise of H.R. 2834 seems to be that capital gains allocated to private equity sponsors should not be respected as such because these sponsors provide services to the funds they establish, or because they receive profits disproportionate to their invested capital.

But capital gains treatment has never depended on the amount or proportionality of capital provided by one investor as compared to another, nor is it denied to an investor whose efforts, as well as capital, drive an investment's profitability.

The proprietors of a small business may invest very little capital and may generate most of their ownership value through personal efforts, but when they sell their business, their profit is a capital gain.

The founder of the technology company receives capital gains from the sale of a stock interest even if he or she contributed only a tiny fraction of the company's capital.

We also hear that owners of carried interest bear no risk. In truth, private equity sponsors bear many types of risks. For starters, private equity partners contribute substantial capital to their funds. While this capital may represent only 5 or 6 percent of a fund's total capital, it usually represents a very high percentage of these partners' net worth.

Private equity general partners also have residual liability for obligations of the partnership, and like other entrepreneurs, private equity sponsors bear the risk that years of effort and foregone opportunities will not result in any significant value for their ownership interest.

Finally, some allege that the current law is inconsistent with tax fairness. But the taxation of carried interest ownership is fair when understood as part of a tax system which for many good reasons taxes long term capital gains at a lower rate than the highest marginal ordinary income rates.

As long as one believes that a lower long term capital gains rate is sound policy, there is no inequity in the current taxation regime. Indeed, what fairness requires is that the Tax Code not single out certain investors or certain types of partnerships for less favorable treatment.

The changes that have been proposed will have economic consequences. I do not suggest that private equity investment will disappear, but it is reasonable to assume that a dramatic tax increase will have a negative impact on private equity and other forms of investment, particularly in a fragile market environment.

In addition, the proposed tax increase could lead to lower returns for pension funds and other investors. It could make U.S. private equity firms less competitive with foreign firms and foreign governments, and it could drive the center of gravity of private equity investing overseas.

I do not believe these economic risks are justified by whatever modest revenue would be raised by the proposals.

Thank you again for the opportunity to present our views, and I would be happy to answer any questions.

[The prepared statement of Mr. Rosenblum follows:]

Prepared Statement of Bruce Rosenblum, Managing Director, The Carlyle Group, and Chairman of the Board, Private Equity Council

Mr. Chairman and Members of the Committee, I am pleased to appear before you today on behalf of the Private Equity Council to present our views on the taxation of carried interest for partnerships. I am a partner and managing director of The Carlyle Group, one of the world's largest private equity investment firms, which originates and manages funds focused across four major investment areas: buyout; venture and growth capital; real estate; and leveraged finance. I also serve as the Chairman of the Board of the Private Equity Council, a relatively new organization comprising 11 of the leading private equity investment firms doing business in the United States.[1] The PEC was formed to foster a better understanding about the positive contributions private equity investment firms make to the U.S. economy.

The Face Of Private Equity

Before addressing the carried interest tax issue, I think it is important to describe private equity investment. Some have a perception that private equity investment is an esoteric form of "black box" finance practiced by a small cadre of sophisticated investors. The truth is that private equity investment is about numerous entrepreneurial firms, large and small, located in all parts of the United States, that are integral to capital formation and liquidity in this country. Some, like Carlyle, do multi-billion dollar transactions; others may do transactions of $5 million or less, locally or regionally; and, in recent years, spurred by programs like the new markets tax credit and empowerment zones, a new cadre of entrepreneurs have turned to private equity finance to make capital investments in underserved urban and rural communities. Private equity investment is also about benefits provided to tens of millions of Americans through enhanced investment returns delivered to pensions, endowments, foundations and other private equity investors. And private equity investment is about thousands of thriving companies contributing to the U.S. economy in many positive ways. When you buy coffee in the morning at Dunkin' Donuts, see a movie produced by MGM Studios, or shop at Toys R Us, J. Crew, Petco, or Auto Zone, to name just a few, you are interacting with private equity companies.

Private Equity Investors

Private equity (PE) investment is driven by private equity firms—known as general partners (GPs) or "sponsors"—which establish a venture in partnership form (typically referred to as a "fund"). The sponsor invests its own capital in the fund, and raises capital from third-party investors who become limited partners (LPs) in the fund. The sponsor uses the partnership's capital, along with funds borrowed from banks and other lenders, to buy or invest in companies that it believes could be significantly more successful with the right infusion of capital, talent and strategy.

Private equity has been extremely profitable for the LP investors who receive most of the profits generated by PE funds. Over the 25 years from 1980 to 2005, the top-quartile private equity investment firms generated per annum returns to LP investors of 39.1 percent (*net* of all fees and expenses). By contrast, the S&P 500 returned 12.3 percent per annum over the same period. This suggests that $1,000 continuously invested in the top-quartile PE firms during this period would have created $3.8 million in value by 2005. The same amount invested in the public markets would have increased to $18,200. *Private Equity Intelligence* reports that be-

[1] The members of the Private Equity Council are Apax Partners, Apollo Management LP, Bain Capital, The Blackstone Group, The Carlyle Group, Kohlberg Kravis & Roberts & Co., Hellman & Friedman LLC, THL Partners, Providence Equity Partners, Silver Lake Partners, and TPG.

tween 1991–2006, private equity funds distributed $430 billion in profits to their LPs. Clearly, top PE funds have been exceptional investments over the past quarter century, a major reason we are able to continue to attract capital from LPs.

The largest category of investors benefiting from these exceptional returns have been public and private pension funds, leading public and private universities, and major foundations that underwrite worthy causes in communities across the country. The 20 largest public pension funds for which data is available[2] currently have some $111 billion invested in private equity on behalf of 10.5 million beneficiaries.

Let me give you a concrete example of what these numbers mean to real people. The Washington State Investment Board, which is responsible for more than $75 billion in assets in 16 separate retirement funds that benefit more than 440,000 public employees, teachers, school employees, law enforcement officers, firefighters and judges, has been a major private equity investor for 25 years. In that time, the WSIB has realized profits on its private equity investments of $9.71 billion. Annual returns on private equity investments made by the board since 1981 have averaged 15 percent, compared to 10.1 percent for the S&P 500. Put another way, the excess returns generated by private equity investments have fully funded retirement plans for 10,000 WSIB retirees.

Other clear benefits of private equity investment include strengthened university endowments better able to extend financial aid and create greater educational opportunities for students in virtually every state in the country, and strengthened foundations better able to carry out their social and scientific missions.

Private Equity In Practice

The best way to understand private equity ownership is to see it in practice. The PEC has been developing a series of case studies documenting the ways private equity firms grow companies and make them more competitive. I want to share three concrete examples from Carlyle's experience.

In 2005, we acquired a company called AxleTech International Holdings, Inc., which designs and manufactures drivetrain components for growing end markets in the military, construction, material handling, agriculture and other commercial sectors. AxleTech was a solid business, but it was focused on the low margin, low growth commercial segment of the market. Under Carlyle's strategic direction, AxleTech developed a concerted business development initiative to offer its axle and suspension solutions to military vehicle manufacturers in need of heavier drivetrain equipment to support the heavy armored vehicles required to protect American soldiers in Iraq and Afghanistan. At the same time, AxleTech expanded its product and service offerings in its high margin replacement parts business while continuing to grow its traditional commercial business. The result is that since Carlyle's acquisition, AxleTech sales have increased 16 percent annually and employment has increased by 34 percent from 425 to 568, with new jobs created in AxleTech's facilities in Troy, MI, Oshkosh, WI, and overseas. Indeed, it is one of the very few U.S. automotive-related companies that are growing in this challenging environment for the industry. And AxleTech's job growth does not take into account the ripple effects on AxleTech's suppliers which are experiencing new hiring and increased capital investments.

In 2002, we acquired Rexnord Corporation, a Milwaukee-based provider of power transmission, bearing, aerospace, and specialty components. While healthy, it was a neglected division of a large British conglomerate. After being acquired by Carlyle and its partners, the company refocused its business on lines with the strongest growth prospects, took steps to improve product quality, inventory management, procurement and customer delivery, made key strategic acquisitions, and developed a plan to expand business in the growing China market. Under Carlyle's ownership, total revenues rose from $722 million in 2003 to $1.08 billion in 2006 and enterprise value doubled from $913 million to $1.8 billion.

Finally, Bain Capital, THL Partners and Carlyle bought Dunkin' Brands (Dunkin' Donuts and Baskin-Robbins ice cream shops) in 2006 from a European beverage conglomerate which gave the business low priority and minimal attention. Under private equity ownership, investing in long-term growth is a key business strategy.

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[2] California Public Employees Retirement System, the California State Teachers Retirement System, New York State Common Retirement Fund, Florida State Board of Administration, New York City Retirement System, Teacher Retirement System of Texas, New York City Teachers Retirement System, New York State Teachers Retirement System, State of Wisconsin Investment Board, New Jersey State Investment Council, Washington State Investment Board, Regents of the University of California, Ohio Public Employees Retirement System, Oregon State Treasury, State Teachers Retirement System of Ohio, Oregon Public Employees Retirement Fund, Pennsylvania Public School Employees Retirement System, Michigan Department of Treasury, Virginia Retirement System, Minnesota State Board of Investment.

Jon Luther, CEO of Dunkin' Brands, recently told the U.S. House of Representatives Financial Services Committee, "The benefits of our new ownership to our company have been enormous. Their financial expertise led to a ground-breaking securitization deal that resulted in very favorable financing at favorable interest rates. This has enabled us to make significant investments in our infrastructure and our growth initiatives. . . . They have opened the door to opportunities that were previously beyond our reach." Today, Dunkin' Brands is expanding west of the Mississippi, and is on track to establish franchises that will create 250,000 new jobs—with the further benefit of creating a new class of small business entrepreneurs for whom owning multiple Dunkin' Donuts franchises is a way to achieve personal financial security and success.

Understanding Private Equity Partnerships

In order to understand the issues relating to the taxation of "carried interest," it is helpful to review the structure of private equity partnerships, how they are formed and owned, and how they operate.

As noted above, private equity investment is typically conducted through a private equity partnership, or "fund." The fund is formed by a private equity firm, or "sponsor," which is itself typically a partnership comprised of the founders and other individual owners of the private equity firm. Typically, the sponsor (or one of its affiliates) serves as the GP of the fund and charges an annual management fee to the fund that ranges from one to two percent of the assets under management. In addition, the sponsor (often through contributions by its individual owners) invests its own capital in the fund, which generally constitutes between 3–10 percent of the partnership's overall investment capital.

A fund's partnership agreement establishes the parties' respective ownership rights and responsibilities from the inception of the fund. Most PE funds are designed to ensure the investors' right to receive a return of their capital and a minimum level of profit *before* the sponsor receives any so-called "carried interest." Thus, under a typical arrangement, when a PE fund sells assets at a profit, the investors are entitled first to their capital back, plus an additional eight to nine percent per annum return on their capital (a so-called "hurdle" rate), as well as reimbursement for any fees paid to the sponsor or its affiliates. Any proceeds remaining after the hurdle is cleared and fees are reimbursed are distributed in accordance with the partnership agreement, typically 80 percent to the investors and 20 percent to the sponsor. This allocation of profits to the sponsor is commonly referred to as a "carried interest."

The carried interest is also typically subject to a "clawback" provision that requires the PE firm (and, thus, the individual partners of that firm) to return distributions to the extent of any subsequent losses in other investments of the fund, so that the sponsor never ends up with more than its designated portion (e.g., 20 percent) of profits. If the fund generates losses on some investments, the sponsor shares in the downside because any profits from its carry on successful investments are offset by the deals gone sour. If enough deals in a fund do poorly, the sponsor could be left with no carry at all. Thus, the sponsor's retention of a carried interest in its funds effectively acts as both a risk-sharing mechanism and as an incentive to find the right companies in which to invest, to use its entrepreneurial skills to improve those companies, and ultimately to deliver outstanding returns for LP investors.

Despite the impression you might have, not all profits realized by a private equity sponsor from a fund are taxed at long-term capital gains rates. Those profits may include many elements taxed at higher rates, including rent taxed as ordinary income, interest taxed as ordinary income, and, on occasion, short-term capital gains. The sponsor (like any other partner of a partnership) is taxed on its allocated share of profits based on the underlying character of the income produced at the partnership level. It is only the allocation of what is indisputably long-term capital gains income—the profits from the appreciation in value of long-lived capital assets, such as the stock of a corporation—that is taxed at "differential" capital gains rates. However, since the core objective of a private equity firm is to acquire businesses, improve their value over the course of many years, and ultimately sell them for a profit, it is typically the case that a large portion of the profits generated by a private equity fund are, in fact, long-term capital gains.

Private Equity Tax Issues

The debate over carried interest taxation has many elements, some of which are technical. I would like to focus my testimony on correcting a series of fundamental mischaracterizations that have emerged as this debate has unfolded. But I have also attached to my testimony a paper prepared for PEC by one of the country's leading

tax professors, David Weisbach of the University of Chicago Law School, which addresses many of the relevant policy and technical tax issues associated with this debate.

A Carried Interest Is Not "the Equivalent" of a Stock Option.

Some have argued that a carried interest is the equivalent of a stock option given to a private equity sponsor in exchange for its "services," and thus should be taxed as ordinary income. I understand the surface appeal of this argument. But upon analysis, it comes up hollow. While carried interests and stock options are similar in the general sense that they increase in value based on increases in the value of underlying businesses, they differ in many fundamental respects.

First, options arise out of an employer-employee relationship. A stock option is a right *granted* by a corporation as *compensation* to an *employee.* By contrast, a private equity sponsor with a carried interest is not an "employee" of the limited partners, but rather is an owner of the venture from the outset, who maintains control over the management and affairs of the venture. In most cases, the venture would not even exist without the sponsor's ideas, driving force, and skill.

Thus, a "carried interest" profits interest is an *ownership interest* in a business enterprise (a fund), created by the *founders* of that business enterprise in connection with their formation of the venture. In contrast to an option, the general partner need not exercise anything to be considered an owner of the venture and receives allocations and distributions in accordance with the partnership terms from the outset. In these respects, a carried interest has much more in common with "founders stock" in a corporation than a corporate stock option.

Partnership interests with carried interest allocations are also typically subject to terms and restrictions (e.g., minimum return hurdles, clawback provisions) not associated with stock options. Moreover, while stock options are used in private companies (including portfolio companies owned by private equity firms), they are most prevalent in public companies, where (once exercisable) they entitle the holder, at any time of his or her choosing, to acquire a liquid security that can almost immediately be converted into cash. If, subsequently, the value of the corporation decreases and its stockholders suffer losses, there are no consequences for the option holder who has exercised and taken this cash. In contrast, the holder of a carried interest typically remains at risk for the investment returns delivered to limited partners over the entire life of the business enterprise (the fund), has residual risk if the venture fails (as discussed further below), and receives cash with respect to the carried interest only concurrent with the limited partners' receipt of cash profits. Thus, the "alignment of interests" between limited partners and holders of carried interests is much more complete than that of stockholders and holders of stock options.

Holders of Carried Interests Bear Significant Economic Risks

Proponents of a tax change have also claimed that owners of carried interests bear no risk, and thus should not be entitled to capital gains treatment on their profits. In truth, private equity sponsors bear many types of entrepreneurial risk.

First, sponsors (and their individual partners) contribute substantial capital to their private equity funds. At Carlyle, this can represent hundreds of millions of dollars invested in a single fund. Whatever percentage of total partnership capital this investment represents, it typically represents a very high percentage of the private equity partners' capital available for investment. This capital is subject to risk of loss, in whole or in part.

Moreover, like other entrepreneurs, private equity sponsors (and their individual partners) contribute ideas, expertise, and years of effort to the private equity partnerships they form and own. Like other entrepreneurs, these sponsors (and their individual partners) bear the risk that this investment will not result in any significant value in their ownership interests. Private equity partners forgo other opportunities that provide greater security and guaranteed returns in exchange for the greater upside potential provided by ownership of their interests in private equity partnerships. But it is worth noting that, according to *Private Equity Intelligence*, 30 percent of the 578 private equity, venture, and similar funds formed between 1991–97 did not deliver any carried interest proceeds to their GPs. The risk of "coming up empty" is real.

Private equity general partners also have liability for the obligations of the partnership to the extent the partnership is not able to meet such obligations, and they may be asserted to have liability to third parties for certain actions of the partnership. In addition, private equity general partners contribute their goodwill, business relationships and reputations to their funds, and these assets are subject to impairment.

Finally, private equity general partners may be obligated as a business matter (even if not legally obligated) to suffer out of pocket losses on the operations of a sponsored partnership. For example, Carlyle formed a fund in early 2000 to pursue a specified subcategory of private equity investments, and at the time the fund had a high level of demand from limited partners. About two years later, however, there had been a major shift in the prospects for these types of investments, and many of the early investments in the fund were in fact performing badly. At the low point, we valued the capital in these initial investments at less than 40 cents on the dollar. As a gesture of goodwill to limited partners, Carlyle reduced the level of management fees; refocused the investment objectives of the fund; gave limited partners a one-time option to reduce their unfunded commitments (some actually chose to increase commitments based on the refocused strategy); and, at additional cost to the firm, brought on additional investment professionals to help execute the strategy for prospective fund investments. Carlyle continued to devote considerable attention and expense to this fund, with the objective of at least returning limited partner capital, even though it was highly unlikely that there would ever be sufficient profits in the fund to support any allocation of carried interest profits. In fact, after several years of effort, it is now clear that the limited partners will receive all of their capital back with a modest profit; there will be no profits allocated to "carried interest" in this fund (since the minimum profitability hurdles will not be cleared); and the fund will be an out-of-pocket loss to Carlyle (i.e., expenses will exceed fees).

Private Equity Funds and Their Partners Own Capital Assets

A third line of argument holds that private equity sponsors are not owners of a capital asset and thus cannot be eligible for a capital gain.

However, it is clear that the underlying economic activity pursued by private equity firms is at its core about the creation of capital gain—i.e., ownership and growth in the value of businesses. There can be no question that capital gains are created when these businesses (typically corporations, which pay their own level of corporate taxes) are acquired by a private equity fund, held for the long-term, and sold at a profit.

As discussed above, the carried interest is simply a feature of the sponsor's ownership interest in the business enterprise (i.e., the fund) that acquires these capital assets. Indeed, it is the sponsor that establishes the private equity fund, sets the investment strategy for the fund and makes the strategic decisions on which businesses to acquire, how to finance the acquisitions and how to run the businesses. It is the sponsor that makes the initial commitment of capital to the private equity fund. And it is the sponsor that raises capital from the limited partners, who are offered in return a form of "financing partnership interest"—an ownership interest that typically entitles them to a return of their capital, the first allocation of profits from that capital until they have received a minimum return or "hurdle," and 80 percent of the profits from that capital once the "hurdle" has been satisfied. The sponsor retains an ownership interest that entitles it to a return of its invested capital, the profits attributable to that capital, and 20 percent of all other profits once the "hurdle" has been satisfied. In sum, a private equity sponsor clearly has "ownership" in the capital assets held by a private equity partnership and, like any other owner, should be taxed at capital gains rates on the profits from the sale of those assets.

Private Equity Sponsors Do Not Benefit From "Loopholes"

A recurring mantra of tax change proponents is that they are simply attempting to "close a loophole" that has been "exploited" by private equity sponsors. Nothing could be further from the truth.

Partnership structures using carried interests, or profits allocations "disproportionate" to invested capital, are pervasive across a broad swath of business sectors. These ownership structures have been used for many years in many contexts, and are commonplace in all forms of partnerships, including real estate, oil and gas, venture capital, small business, and family business partnerships. The flexible partnership structure, in which capital, ideas and strategic management can be provided by different partners, who split profits according to agreement, has been critical to the legacy of entrepreneurship that characterizes the success of American business. And the tax treatment of this ownership structure is well settled. It can hardly be called a "loophole."

Likewise, the principles underlying what is and what is not a capital gain are well settled. Capital gains treatment is not tied to subjective evaluations of the level of "risk" taken by an investor or the "worthiness" of an investment; nor is it dependent on the amount or "proportionality" of capital provided by one investor as compared to another investor; nor is it denied to an investor whose efforts, as well as capital,

drive an investment's profitability. Instead, the rules governing capital gains are simple and straightforward: if you own a capital asset, hold it for more than a year, and sell it for more than you paid for it, you are taxed at long-term capital gains rates.

Thus, the proprietors of a small business may invest very little capital in the business, and may generate most of their ownership value through their personal efforts over many years; when they sell the business, their profit is nonetheless treated as capital gain. An entrepreneur receives capital gain treatment when he or she buys a run-down apartment building at a "fire sale" price, invests years of labor rehabilitating and leasing the building, and sells it at a profit. The founder of a technology company may put very little capital into a business formed to develop his or her ideas. Over the years, as he or she raises equity financing from third parties, his or her ownership share may significantly exceed his or her share of overall capital invested in the business. Nonetheless, the founder will receive capital gains treatment on the sale of his or her stock ownership, even though he or she has provided only a small percentage of the overall capital invested in the business.

"Tax Fairness" Does Not Require Treating Carried Interest Proceeds As Ordinary Income

Perhaps the signature argument advanced by proponents of a tax change is that such a change is needed to restore "fairness" to the tax system.

Tax fairness is an important value. All of us should pay our fair share of taxes. And I believe that the taxation of carried interest ownership interests is fair when understood as part of a tax system which, for many good policy reasons—encouraging long-term investment and risk-taking, avoiding "lock-in" (i.e., significant disincentives to selling a capital asset), mitigating the double taxation of corporate-produced returns, and minimizing the tax on "inflationary" returns—taxes long-term capital gains at a lower rate than the highest marginal rates applicable to ordinary income. In each case, the justifications for a differential long-term capital gains rate apply equally well to capital gains derived from carried interests as they do to capital gains derived from other forms of ownership interests. Thus, as long as one believes that taxing long-term capital gains at a lower rate is sound tax policy, something Congress has affirmed repeatedly, there is no "inequity" in the current taxation of capital gains attributable to carried interests. Indeed, I believe that fairness requires that the Tax Code not single out certain investors for less favorable treatment.

Moreover, it is worth noting that private equity partners do not *exclusively* receive long-term capital gains, nor do they pay taxes at an "effective tax rate" of 15 percent. As noted above, profits allocated to carried interests often include elements taxed as ordinary income, and private equity firms receive fees taxable as ordinary income. In addition, many private equity partners receive salary and bonus income that is taxed as such. It is only to the extent that they receive their allocable share of long-term capital gains attributable to their ownership interests that private equity partners are taxed, fairly, at long-term capital gains rates.

In fact, many of the commentators who have raised "fairness" issues about carried interest taxation have also expressed the view that the "bigger problem" is the differential long-term capital gains rate itself, which such commentators say should be abolished altogether. Regardless of whether one agrees with this position (I do not), I believe it is at least more "conceptually coherent" than carving out for "special treatment" the capital gains received by private equity and venture capital firms, as HR 2834 seeks to do. There is no justification for treating capital gains allocated to private equity sponsors less favorably than other capital gains—including those earned by other successful investors and businessmen, whether they be Warren Buffett, Bill Gates, or persons of more modest means who have successfully invested in the stock market or a small family business.

Nor is it accurate to describe carried interest taxation, as some have, as a "tax break" that helps the "rich get richer." If anything, the history of the carried interest is that of the "not particularly rich"—and the "not rich at all"—getting richer. There are numerous examples of private equity, real estate and oil and gas entrepreneurs from modest backgrounds building wealth through value-creating enterprises that included carried interests as part of their ownership structure. The relentless media and political focus on a handful of highly successful founders of large private equity firms ignores the fact that these individuals (like many other successful business founders) were not necessarily "rich" when they started their businesses.

Also ignored are the many thousands of business founders who employ carried interest ownership structures in small to medium size enterprises, or in "start up" businesses that are still struggling to get themselves off the ground.

Ironically, H.R. 2834 and similar proposals would create more of a "rich get richer" environment, by providing that capital gains generated in certain types of partnerships will be respected as such only to the extent allocated to partners "in proportion" to invested capital. Thus, only those who are in a position to provide significant risk capital—and not those who build these businesses through their ideas, vision and effort—will be in a position to derive significant benefit from differential long-term capital gains rates.

This is one reason why the newly formed Access To Capital Coalition, which represents many African-American and women entrepreneurs and investment firms, has said that "Carried interest has played a vital role in attracting highly talented and committed risk-taking minority and women entrepreneurs to the investment capital industries. It also has served, and has the capacity to serve to even greater degrees, as a mechanism for increasing minority and women entrepreneurs' access to investment capital and capital investments in underserved urban and rural communities.

"We believe that because of its direct impact on minority- and women-owned firms, and its broader impact on the investment capital industries as a whole, the legislation could impose a significant financial burden on minority- and women-owned investment capital firms, both with respect to their profitability and maintaining and improving their access to investment capital, vertically and horizontally. These developments could threaten the viability and stifle the growth of many minority- and women-owned firms and managers in the industries. Also, because of its larger effect, the legislation has the potential to significantly curtail access to investment capital for minority and women entrepreneurs and many of the communities that they serve."

The Law Of Unintended Consequences

Finally, proponents of the proposed legislation claim there is no risk that it will create adverse consequences for long-term investment or the economy. I wonder how they can be so sure. I have been careful not to declare that the sky will fall or that private equity investment will disappear if these changes are enacted. Quite the contrary, private equity firms—at least those, like Carlyle, that have become large and well established—will survive. But predicting how markets will respond to such a huge change in the economic structure of private equity investment—or assuming that such activity will go on as if nothing happened—is naïve, especially during a time of considerable market sensitivity to external events.

I cannot predict what actions Carlyle or any other PE firm will take in response to a tax change. And no one can predict the consequences of a tax change with absolute certainty. Tax costs are but one of many variables affecting private equity investment activity. Other factors, including interest rates, access to capital, market liquidity, and sector and macro economic trends are all relevant. But a change in carried interest taxation is clearly a relevant variable in the extent to which such activity will be pursued. And it is worth noting that since capital gains rates were lowered, the pace of private equity investment activity has increased significantly. I think it is reasonable to believe that a dramatic tax increase will indeed have a negative impact on private equity investment.

Of course private equity sponsors will continue to meet their responsibilities to their limited partners, even if the "rules of play" are changed in the middle of the game. And, of course, we will pay taxes on whatever basis is determined by Congress. But over time, investment structures will change; incentives for new fund formation (or formation of new PE firms) will be diminished; and there will inevitably be less activity in the sector, at least by U.S. firms with U.S. owners. I believe Congress ought to proceed very carefully before risking an adverse impact on a form of investment that has been a major and positive force in strengthening U.S. competitiveness, giving struggling or failing businesses a new lease on life, and pumping critically needed capital into the economy.

In addition to the general economic harm that could occur from diminished private equity investment activity, let me cite three specific potential consequences which should cause concern.

Lower Returns For Investors: It may be that sponsors can develop new financing models that ensure the same level of return to PE firm partners and our LP investors—although, if we do, it is likely that these new structures would significantly reduce any anticipated tax revenue expected from this change. But alternatively, PE sponsors may look at ways to offset the higher tax burden through changes in economic terms that will adversely impact their LPs. A likely result would be the eventual reduction in the returns of pension funds, endowments, foundations, and other investors who rely on these returns to carry out important social missions. This is exactly why Pensions and Investments Magazine, the leading trade

journal for many such investors, recently said in an editorial that "pension funds, endowments, and foundations, even though they are tax-exempt institutions, might end up paying the increased taxes Congress is considering imposing on the general partners of hedge funds and private equity firms. . . . The result: lower returns for the pension funds, endowments, and foundations."

Loss of Competitiveness: Another possible consequence is that U.S. firms will become less competitive with foreign PE firms, and even foreign governments with huge investment war chests. The Wall Street Journal noted in a recent article that the world's capital is going global, reporting that many sovereign governments are actively seeking investment opportunities worldwide. They, and the major foreign PE firms with whom we compete, will not be as constrained by taxes, and will be in a more competitive position to acquire companies than U.S. PE firms with a higher "cost of capital."

The U.S. is the dominant capital market in the world, and this Committee has been very supportive of protecting that status. But it is odd that, as governments the world over are striving to make their tax systems more competitive to attract foreign capital and challenge U.S. dominance, this Congress is considering a proposal that would go in the opposite direction.

Migration Of Capital Activity: A third possible consequence is that private equity activity will increasingly move overseas. There has been considerable misunderstanding about this risk, with some dismissing the prospect of major U.S. PE firms relocating. However, the concern is not that PEC members or other well-established U.S. private equity firms will relocate their U.S. operations—indeed, I think this is not highly likely. Rather, the question is whether the U.S. will be the home for the next generation of PE entrepreneurs, who will have discretion to start their businesses wherever the climate is most favorable. Will the "center of gravity" migrate to Europe, Asia, the Middle East, or Eastern Europe, where firms will tend to seek first investment opportunities in their own regions? Will the U.S. see growth capital now invested to strengthen American companies shifting to help foreign firms better compete against U.S. businesses? And are the perceived benefits of this change in tax policy worth taking that risk?

Tax Treatment of Publicly-Traded Partnerships

I do want to address an issue that has received considerable attention recently. Although the focus of this hearing is not on the tax treatment of publicly traded partnerships, I would like to provide the committee with a few observations regarding legislation which would deny partnership treatment to certain publicly-traded partnerships that derive income (directly or indirectly) from services provided as an investment advisor or from asset management services provided by an investment advisor.

We oppose the bill on several grounds. It inappropriately singles out our industry for exclusion from the general rules for qualification as a PTP. In doing so, it will discourage private equity firms from going public in the U.S., impeding potential benefits both to such firms and the U.S. capital markets. Those PE firms which do go public will be subject to a "triple taxation" regime, with the same income potentially taxed at the portfolio company level, at the public entity level, and at the investor level. And, despite all of this dislocation, the incremental tax revenue produced by the change is unlikely to be meaningful.

Virtually all private equity firms are organized as partnerships or other "flow through" entities today. Thus, going public as a PTP simply preserves the status quo for tax purposes. There is no abuse or tax evasion involved. In fact, public PE firms would generally conduct a portion of their operations through a corporation, thus subjecting to corporate taxation income which is not subject to such tax under private ownership.

Under the current law, there is a general standard for PTP qualification: 90 percent of income must be qualified income, such as dividends, interest and capital gains. The private equity industry is not seeking "special treatment" but simply the ability to use a structure that is made available to, and used by, other sectors, such as oil and gas. There is no justification for singling out PE firms for adverse treatment.

Indeed, exclusion of PE firms is particularly inappropriate given that their activities center around investments in corporations that are themselves taxable entities.

Thus, income earned by these firms would be subjected to three levels of taxation: (i) the first level of corporate tax would be paid by the investment funds' portfolio companies on their operating income; (ii) the second level of corporate tax would be paid by the PE sponsor on its share of the gain from the sale of the portfolio companies or on distributions received from such companies; and (iii) the third level of tax would be paid by the public owners of the PE sponsor when they sell their shares.

Because of the overall structure, the dividends-received-deductions would generally not be available to ameliorate the three levels of tax. Thus, the PTP bill appears to impose a penalty on publicly-traded PE firms that corporate enterprises in foreign jurisdictions do not bear, and which most other corporate enterprises in the U.S. do not bear (by virtue of consolidation or the dividends-received-deduction).

This penalty will constrain the ability of mature private equity firms to raise capital in the U.S. public markets that may be required to compete in an intense and increasingly global business. In turn, U.S. public market investors may be deprived of an opportunity to participate in the next phase of growth of this sector, and the competitiveness of the U.S. capital markets will suffer.

We understand that the bill was driven at least in part by a concern over erosion of the corporate tax base. However, as noted above, conversion by private equity firms to PTPs would simply preserve the status quo. Other financial firms organized as C corporations have not shown an inclination to organize as PTPs despite the opportunity to do so. Financial corporations contemplating a change to PTP status generally would face significant corporate taxes upon conversion, which will often be prohibitive.

Finally, the transition to public ownership may be important in succession planning and allowing a mature PE firm to survive beyond its founders. By discouraging and possibly precluding such steps, the bill imposes unfair limits on the ability of these firms to fully realize their potential.

I would like to thank Chairman Rangel and Ranking Member McCrery again for the opportunity to present our views on these important issues. We look forward to working with you and the other Members of the Committee in the weeks ahead. I would be happy to answer any questions you might have regarding these issues.

Chairman RANGEL. Thank you, Mr. Rosenblum. Members are waiting to ask questions. I just want to confine mine to Mr. Silver.

Mr. Silver, are there people in the corporate world that manage funds and do the same thing as equity partners do in the private sector, and you might say they put in sweat equity because they are working hard in order to protect and expand the profitability of the funds.

I want to make it clear to this panel, no matter what the testimony is, if at the end of the day we can reach the conclusion that the system as it exists is equitable because one group formed a partnership, the other group formed a corporation, we have to find some reason, and I am not convinced by your testimony, Mr. Silver, that what you are doing is that much different from what somebody in the corporate investment banking business is doing, especially if we are talking about no direct money investment being made.

Could you share with me why there should be this difference in how the fee that is received by the person that is doing the work, the good work for venture capital, should be different from your competitor whose fee is treated as ordinary income and your group's fee would be considered as an investment and return on capital?

Mr. SILVER. Yes, Mr. Chairman. I would be happy to try to address that. I assume by your question that you are actually referring to in the case of venture capital, corporate venturing as opposed to investment banking, per se.

Chairman RANGEL. Those that you normally consider a competitor, that you are doing such extraordinary work that your clients would believe that is so different, and one would assume that you are entitled to a different type of compensation.

It has been difficult for a lot of Members of this Committee, without targeting you or anyone else, to see how you feel comfortable

in distinguishing your work from the corporate work and deal with the same type of thing.

Mr. SILVER. I think there are a number of important distinctions. I will simply in the interest of time identify a couple.

One was mentioned here among the panelists' remarks, and that is the general partners of individual venture funds are significant investors in their own funds. A substantial portion of the net worth of the individual general partners is generally also in the pool of capital that is being invested.

Chairman RANGEL. Do you have to make any investment at all as a partner in order for your fee to be treated as capital gains? Do you have to put any money at all in the venture?

Mr. SILVER. Every general partner at Core Capital and every general partner in every venture fund I am aware of has made a significant personal financial investment.

Chairman RANGEL. I thought you spoke a lot about sweat equity in terms of the value of the investment.

Mr. SILVER. I did. I was trying to originally answer the question you asked about the distinction between independent venture funds and corporate venture funds.

The first and most obvious distinction is that——

Chairman RANGEL. I do not think there is much difference in how those who invest their funds are treated as capital gains or the return on investment. That is not a problem. You understand that? It is not a problem that the partner is investing capital, how the return on the capital they invested is treated, that is not a problem.

What I want you to address is those services that are provided that are not direct financial investments, how that, too, is treated as capital gains. That would help me.

Mr. SILVER. In the day to day practical world of venture capital, it is almost always the case that independent venture funds are in fact the lead investors in starting new companies, and the corporate venture funds, to the extent they participate, tend to be follow on providers of capital.

The actual work, the sweat you are referring to, the sweat equity you referred to——

Chairman RANGEL. You referred to.

Mr. SILVER. That I referred to that you were making reference to, is largely undertaken by firms like mine. We work side by side along with the entrepreneurs to build these companies from scratch. We are involved from the outset in doing everything that an individual does who puts a company together.

We hire management teams. We build strategic plans.

Chairman RANGEL. People who come from the corporate world, they do not do these things that you do?

Mr. SILVER. Corporations do. The venture arms of corporations, which is what I think you are referring to, are generally providers of capital to invest in ideas and emerging companies which generally have some potential strategic importance to the corporation.

Chairman RANGEL. I am only talking about services rendered that are not direct investments. I want to make it clear. You invest, whether you are a partnership, a corporation. To someone like

me, it makes sense they should get the same return on their investment.

I just want you to try to help me to distinguish between people who make no direct capital investment, they are just concerned about going into minority communities and taking projects on that no one else would take, bringing people together, reforming the system, putting in sweat equity, at the end of the day, somebody gets an ordinary income and somebody else gets capital gains.

The person that gets the capital gains, for purposes of our discussion, did not put up any equity other than sweat equity.

That is the problem as to whether or not there is some other reason——

Mr. SILVER. I do not know of any venture fund in which the partners do not as part of the pool of equity being invested participate themselves directly—who do not participate themselves directly, and I do not know of any venture fund where it is not true that the investment is going into the creation of a capital asset.

The creation of the company is the creation of the capital asset.

Chairman RANGEL. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

I want to ask about two things, because we have talked about this some already today. Number one is risk. Several of you talked a good bit about risk and how general partners have inordinate risk compared to say somebody working for UBS or CitiBank or whatever.

Number two, if the Levin bill were to pass, are there not ways that businesses, Mr. Stanfill, like yours, or Mr. Rosenblum, like yours, could reorganize and get around this, to get the same capital gains treatment?

Mr. ROSENBLUM. I think the most fundamental point here is not that we are harder working or smarter or more deserving in some general sense than anybody else. We are owners. We form businesses. We take risks, both with our capital and with our time, and with being a manager with residual liability for the business, and with worrying on occasion of going out of pocket to swage the limited partners that we have raised money from.

We are not asking to be treated better or worse than other businessowners, but we are asking to be treated like businessowners. I think risk is certainly part of that.

In terms of alternate ways of approaching it, I think one of the striking things about the bill that has been proposed here is that it changes taxation only on a particular type of structure and a particular type of financing.

It does not change the taxation on the underlying activity that we are performing, which is going out, buying a business, improving it, and selling it.

You have to ask yourself is there a different way to conduct that business? Is there a different way to raise that financing? Of course, there is.

We have not studied all the alternatives that may be available.

Mr. MCCRERY. But you probably would, would you not, if this bill were to pass?

Mr. ROSENBLUM. I am sure we would have many accountants and lawyers on our door step if a bill is passed to talk to us about

it. There are very simple things that have already been mentioned by some of the other panels, taking debt financing and pursuing it that way.

What we are getting from limited partners is a form of financing. It has been very beneficial for them because they get to participate in the vast majority of the profits that are created by this business, but there are other ways to obtain financing.

Mr. IFSHIN. Representative McCrery.

Mr. MCCRERY. Quickly, because I want to give Mr. Stanfill a chance.

Mr. IFSHIN. I will be very brief. As it relates to risk, in a real estate setting, the general partner frequently takes on risk that if a project runs into difficulty or fails, can cause them to incur actual dollar losses.

I think it is important to understand that because in many fund settings, that may or may not be potentially possible. I do not know. If a real estate developer sets out to develop a project, gets his entitlements, gets his limited partners lined up and gets a construction loan, he probably is going to have to personally guarantee that construction loan. If that deal goes bad, that developer could very well lose millions of dollars against a potential profit that may have been a fraction of what he actually loses.

Mr. MCCRERY. Mr. Stanfill, do you have any thoughts on this?

Mr. STANFILL. Just a quick comment, sir. It strikes me that the biggest risk that my partners and I take is making poor judgments in our investments and not earning a good return for our investors, and therefore, not earning a carried interest for ourselves.

We are well compensated whether—I have been well served by capital gains, clearly. I do not think—it is a fairness issue with me. I do not think I pay a particularly heavy price by paying the same rate on my compensation that other people pay.

Mr. MCCRERY. Mr. Stanfill, if you take this conclusion to its logical extension, the conclusion that Mr. Rosenblum reached, that of course, we will organize in some different business set up to get the same treatment, because the underlying—the treatment of the underlying asset and sale of the asset is not changed by this bill, so the logical extension of that is we will chase that next form of business organization, and then the next form, until we do not have any preferential treatment for capital gains any more.

Is that your desire? Would that solve your fairness problem if we just did not have preferential treatment for capital gains?

Mr. STANFILL. Not capital gains that apply to compensation, sir.

Mr. MCCRERY. No, I am talking about capital gains for the sale of a capital asset. Do you want to keep that preferential treatment in the Tax Code or not?

Mr. STANFILL. I have no trouble treating all income, be it dividends, capital gains, ordinary income, at the same rate. We are talking in that case about a total revision of the Tax Code, and I think that is unlikely.

Mr. MCCRERY. Right. That is a totally different question. We have had a couple of witnesses today who have suggested that there should not be preferential treatment for capital gains, and that discussion we have not really explored very well in this Com-

mittee. I am hopeful that is not the intent of the authors of the legislation that we are discussing.

Chairman RANGEL. Mr. Crowley from New York.

Mr. CROWLEY. Thank you, Mr. Chairman. Let me thank the panel for their steadfastness and remaining and contributing to the discussion today.

I have been following this issue, as many of you know, for some time now, and listening to all sides, and have had an opportunity to meet with some of you privately.

Mr. Rosenblum, you stated previously that private equity investments, and I quote, "Will not wither up and die," if the Tax Code is changed, but that "Rather, there will be deals that won't get done. There will be entrepreneurs that won't get funded, and there will be turnarounds that won't be undertaken."

Additionally, Mr. Ifshin, you have stated "If current law is changed to tax carried interest at the ordinary income rate, then the investment viability of real estate projects will surely be brought into question."

Both of these comments appear to indicate that investors make economic decisions based on tax law as opposed to a profit potential.

Would you agree with that statement that I just made and the observation I just made, and would altering the tax rate on investment fund managers alter the tax treatment of investors?

Mr. ROSENBLUM. What I would say is that entrepreneurs and people who fund enterprises like a private equity firm, like a private equity fund, make decisions based on a risk/reward basis. Certainly, the tax cost of doing business is part of that risk/reward equation.

I think it is just simple economics that there will be some contraction of the pool of activities that will be attractive to both the general partners trying to run these funds and the limited partners who are being asked to invest in them or other sources of capital, that will in the end result in fewer types of deals getting done.

I agree with Mr. Ifshin that probably the place that happens first is at the margins with the deals that are viewed as a bigger risk, a bigger stretch, a longer time commitment, in some way more speculative and further out on the risk/reward scale.

Mr. CROWLEY. Mr. Ifshin.

Mr. IFSHIN. Certainly. Since Congress first adopted partnership tax treatment some 50 plus years ago, private real estate investment has utilized that format with a flow through of capital gains treatment from the appreciation of a capital asset. That has led to substantially the overwhelming majority of all development, redevelopment, from New York City to San Francisco.

I do not know of any sophisticated real estate owner or developer who looks at project profitability solely on a pre-tax basis. Tax considerations have been embedded in real estate investment and developer go forward or not go forward or take risk or not take risk decisions as long as I have been in the business and certainly for two generations before me.

The use of the partnership as a vehicle, and embedded in that capital gains treatment for the general partner, has been embedded in real estate transactions since the law was enacted, and in fact,

the partnership form had been used by two generations of real estate developers before anybody ever created the concept of a hedge fund or a private equity fund.

Mr. CROWLEY. It is safe to say that profit is still a mighty incentive?

Mr. IFSHIN. Profits are always important, but the net profit after tax is what at the end of the day as an entrepreneur you can take and re-invest in another project and create more jobs, or take home and feed your children with the proceeds.

Mr. CROWLEY. I thank you both. Mr. Stanfill, you previously stated that a lower tax rate for carried interest is neither fair nor equitable and that venture capitalists get ample compensation, "financial and psychic" for the work they do.

As venture capitalists are the ones providing their own capital for innovations, the more they are taxed, the less funds they have to re-invest back into innovations.

Could that lead to what Mr. Rosenblum has stated previously, that some deals simply will not get done?

Mr. STANFILL. I think it is possible that some deals will not get done, but it strikes me as marginal. I may be missing something. I just do not see this as a serious——

Mr. CROWLEY. I am asking in light of the results of a study that show that in approximately 62 percent of all venture capital deals, people either lose money or just break even. There is apparently tremendous risk in terms of that.

Mr. Silver, you might want to make a comment on that.

Mr. SILVER. Yes, Congressman. I think you are exactly correct. The most important idea to take away from venture capital is that you must have winners to offset your losers, and you do not know which investments are going to be the winners when they start. You hope they all will be. They are not.

The study statistics that you cite are common knowledge. I think they are right. The vast majority of investments that venture capitalists make fail or fail to return significant enough sums to cover and return capital to the general partners and to their investors.

Consequently, I believe what will happen as you move capital gains tax rates up is you will force the general partners in venture funds to make decisions about kinds of investments which alter those investments. We will move to later stage, less risky, shorter term kinds of investments, and consequently will not make investments in earlier stage, riskier kinds of companies, which are themselves the companies that have been the greatest engines of economic growth in the United States.

Mr. CROWLEY. Thank you. Thank you, Mr. Chairman.

Chairman RANGEL. Thank you. Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman. Again, thank you all for your patience. It has been a great hearing.

Let me ask a quick question of all of you. It is obvious that everyone here indicated that you do participate in investment activities and therefore carried interest would apply.

If by chance we were to enact legislation similar to the House bill before us and it would affect the issue of carried interest and its treatment as ordinary income as opposed to capital gains, would any of you leave your business?

I just want to hear from those who would leave.

[No response.]

Mr. Ifshin, you talked about real estate and how you deal with a physical asset, real estate or a structure that you develop on that real estate. You talk about some of the risks imposed.

I will ask you two questions. First, can you continue to provide this Committee with as much information as you can about that risk, where you distinguish between that hard asset versus money or security which is the asset in other private equity investments?

Secondly, a more direct question and a quick answer, and then you can follow up with written testimony if you want to elaborate, should we treat real estate investments where carried interest is a form of—you do not want to call it compensation—there is a reward in carried interest, should we treat real estate differently than we do other types of investments, private equity investments?

Mr. IFSHIN. We will follow up with written testimony. The short answer is—I am certainly not a tax lawyer and do not purport to be one—the way it has been explained to me, if we are using the same form of partnership, then there is not a way to distinguish between the two.

Mr. BECERRA. If there were a way to distinguish, should we?

Mr. IFSHIN. I am not intimately familiar with their business. I do not know intimately whether or not I can make a qualified judgment for you.

Mr. BECERRA. That is fair. I appreciate your trying to respond. Mr. Rosenblum, you mentioned something about pension funds might receive or see a lower return on investment if we were to pass this House bill.

I believe there was testimony today by Mr. Russell Reed, the Chief Investment Officer of the California Public Employees Retirement System, indicating that he had no great concern if we were to make moves to tax the carried interest or at least propose a different tax treatment for the general partners in some of these arrangements.

If you could follow up with us and provide any information that led you to make the statement that the pension funds might suffer lower returns, which obviously would be a concern to a number of us because many pension funds obviously are based on what employees/workers, who do by the way pay ordinary income rates, what their returns would be for their retirement accounts.

If you could provide anything in writing subsequently, that would be very helpful.

Mr. ROSENBLUM. Certainly.

Mr. BECERRA. Mr. Hindery, you heard the testimony from some of the individuals who do raise concerns about changing the treatment of carried interest. If you could comment, and again, if you could try to be specific and brief, for example, I am interested in any comments you have with regard to the issue of the real estate industry and where currently some general partners in the real estate industry actually have to carry paper if the investment falls down and they are stuck with the paper, which the banks ultimately want payment, if they run into an issue of environmental clean up, comment.

Mr. HINDERY. Congressman, I will try to be brief. Some on this panel would have you believe there is somehow a direct correlation between their personal taxation as a hedge fund or private equity manager and the vitality of these underlying activities.

We hear about Google and FedEx, and I am thoroughly impressed. There is no correlation. If there was a correlation, when Mr. Bush had his tax cut and reduced capital gains rates, we should have cut our management fees. There have been six distinct rate changes in the last 20 years in capital gains.

These rates have not adjusted. If you take Mr. Rosenblum, an extremist, in a perfect world, we should pay no taxes because then we would be extremely vital. It is apples and oranges, Congressman.

On the real estate side, to Mr. Ifshin, if Mr. Ifshin in fact does put capital into his project, he has become a capital investor in it, and is entitled to capital gains treatment, capital gains loss and gain.

We are talking simply about the management fee of those of us who have the privilege of running other people's moneys. On that one point, none of us came up here and offered to debate with you and talk with you about cutting our fees when the capital gains rate went down.

Now you are trying to simply move us to a level of taxation that every other regular American pays on his or her management fees, and to tie the vitality of these three industries, now four, in Mr. Ifshin's case, to this issue is one of the great obfuscations I have ever confronted.

Mr. BECERRA. Mr. Chairman, I know my time has expired. Can I just make one clarification? I think, Mr. Chairman, when you had a colloquy with Mr. Silver, Mr. Silver mentioned the fact that most general fund managers that he is aware of made an investment, their personal investment, in these investments.

I think we have to be clear. I think the legislation that Mr. Levin is carrying would treat any personal investment that a fund manager makes as a capital gain on the sale of that particular asset, so we have to make sure we are clear.

If you yourself as a general partner or fund manager make an investment of your own resources into this fund, you will receive capital gain treatment upon the sale of that particular asset, not ordinary income treatment.

Thank you.

Chairman RANGEL. Mr. Levin, the author of the bill.

Mr. LEVIN OF MICHIGAN. I will be brief. Mr. Chairman and Mr. McCrery, this has been, I think, a very long but useful day.

We are determined under the leadership of our Chairman to have these kinds of hearings, to open up these kinds of issues, to not simply look the other way, because our constituents are insistent that a Tax Code works when there is fairness, when there is equity, and when there are distinctions made that are rational, that are justifiable.

They want distinctions that we can explain to them and that we can tell them they make good sense in terms of equity and in terms of growth.

Let others carry on. I just wanted to say to you, Mr. Silver, and we have had a chance to talk before, and our door is always open, as everybody's door is here.

When you say we invest our time and lots of it, we work with the management team often on a daily basis developing strategy, introducing the company to customers and suppliers, identifying and hiring key managers, and leveraging our past experience to address competitive and operating issues, that strikes a lot of people as the kind of work they do. In the real estate business, they may well be doing some of this when they are selling a house.

You talk about risk, I do not think you can base a tax policy basically on risk because there is so much risk in what everybody does.

You mentioned the person who takes the stock option. There is immense risk and you can try to distinguish it if you want, or others, and there has been reference here to people who work on commissions or who work on bonuses. There are lots of people, and this relates to your question, Mr. Chairman, who are in the stock industry, who make more from the bonuses than they do from their other pay. They have immense risk as to what they are going to earn. Immense risk.

We have to be able to tell our constituents who risk a lot, who work hard, who do lots of things more or less as you have described here, why there should be a differentiation, a distinction.

The gist of this effort is to try to have a Code that has fairness, equity, and draws distinctions that are sustainable to our constituents. As Mr. Rangel has said, our Tax Code in terms of compliance is based more on the people's feeling of equity, of balance, of legitimate distinctions than anything else. If it is not there, it collapses.

I will yield the rest of my time so others can carry on. I am going to have to leave to talk about this issue with a colleague of mine in another setting.

This has been a vitally useful effort. I just want to echo what Mr. Rangel has said. This is not an effort to soak anybody. This is a search for a Tax Code that really makes sense and makes distinctions that we can defend.

Mr. SILVER. Congressman, I appreciate your comments. You and I did have a chance to have a very productive conversation privately at an earlier date. You have spoken eloquently about the issue of fairness, and it is clearly a very important question.

I would like to leave you and Members of the Committee with a better understanding than perhaps I have of the unique role that the venture capital community plays in here and with respect to fairness, we play the same role in building companies that the founders and entrepreneurs do.

The question about fairness, we invest our time and our money like an entrepreneur does. The entrepreneur receives capital gains for that work. The question of fairness that you are addressing is a broader macro level question, which is much warranted and ought to be examined, I think, in a much more holistic fashion.

The fairness issue here is really a question of the tax treatment of the kind of work done between the venture capitalist as investor/co-founder and the entrepreneur, not a question at the more macro level of tax fairness within the Code.

Mr. LEVIN OF MICHIGAN. You can shape it that way.

Mr. Stanfill, you do not seem to agree with that.

Mr. STANFILL. I respectfully disagree. I have bright, young, well educated partners, sometimes we lead deals. Sometimes we follow on deals and others lead, and our tax treatment is the same. It simply does not strike me as fair or equitable.

Mr. LEVIN OF MICHIGAN. The red light is on. Thank you.

Chairman RANGEL. Thank you, Mr. Levin. Mr. Tiberi.

Mr. TIBERI. Thank you, Mr. Chairman. That is a tough act to follow. I just want to thank you and Chairman Levin for your sincerity, not only in this legislation, but in this hearing.

I want to thank Mr. Ifshin for putting a different face on this. Let me tell you about a different face that I saw on this issue in August in my district.

Mr. Rangel and Mr. Levin's legislation gets a lot of attention in the media about how it affects Wall Street. My district is far from Wall Street. Let me tell you a little bit about some of the interaction that I had.

In Ohio, we have five public employee pension systems. My mother-in-law, a single mom, a grandma, was a school secretary. She is on one of those systems. She has great returns compared to Social Security. In fact, all of our five pension systems do much better than Social Security does, and they all love their systems. Teachers, firefighters, police officers, local and state employees.

In talking not to the political people but a few of the folks that run a couple of these pension systems, the comment to me was do not think that returns are not going to be impacted by tax treatments.

That is something my mother-in-law has concerns about. This is not from any Republican or Democrat or Union official or state official. People who are involved in the funds themselves.

More important than that, I talked to a guy who is an Italian immigrant. He is a stone maker, along with the brick layer, and Mr. Pascrell is not here, but my Italian friend, Mr. Crowley, is, and a carpenter, three guys who came from Italy, who have formed a real estate partnership. Now they do real estate development, home building.

They believe that this will have an impact on their business. A very Main Street issue, not a Wall Street issue, but a Main Street issue that Mr. Ifshin, you put a face on.

I was at the James Cancer Hospital in Columbus, one of the ten cancer hospitals in America accredited by the Federal Government, and met with an inventor that now uses a cancer device that it took years to get on the market, and if it was not for venture capitalists, it may not be on the market today.

He said to me be careful what you guys do because this was hard enough to get, and if you make it tougher to get, what is the next invention that is not going to be on the market.

What I am saying, Mr. Chairman, is I understand that you are sincere in trying to close loopholes, but what we do here does have impact on real people outside of Wall Street, whether it is a real estate developer who was a stone maker, whether it was my mother-in-law who was a school secretary, or whether it was an inventor who could not get something to market without venture capitalists, and all believe there is concern there.

What I want to ask all of you, just to make a comment, as I look at this legislation, and I have talked to a tax lawyer who said to me you guys are trying to make this more equitable, but in this legislation, it appears to me you are picking winners and losers.

My question to all of you is how do we draw the line here in Congress? How does the Chairman pass a piece of legislation with my support and Mr. McCrery's support and bipartisan support when we are essentially saying if you are in real estate, your capital gain is going to be treated as ordinary income but if you are in another industry, your partnership is not, and are we heading down a road of making the Tax Code even more inequitable than it already is?

Mr. Hindery.

Mr. HINDERY. Congressman, two quick comments. I think the only way to approach this is across the spectrum of investment partnerships. I think when you cut to the nub, we are all the same.

There are six of us that have the privilege of being up here right now. Only Mr. Kramer speaks for the investor crowd. The rest of us are managers. I defer to his comments which makes the point strongly that the investor community is indifferent, the concerns that your mother-in-law has, I do not believe deep in my soul, are concerns that she needs to have.

It is not an issue for the investor community. It is simply a personal taxation issue for those of us who are managers.

I think the answer for this Committee and this Congress is to treat all of these investor partnerships exactly the same, that which is by its nature ordinary income, tax as such. That, to Mr. Ifshin's comment, the concern about real estate, legitimate. That which is capital, treat as capital.

I think there is very bright lines, Congressman, that can be drawn to let you and your colleagues make that distinction for us as we go forward as practitioners.

Mr. TIBERI. Thank you.

Mr. STANFILL. I essentially would agree with that comment. I think capital should be the key.

Mr. KRAMER. Actually, I respectfully find it scary that I do believe there probably are people in the public pension world that you can talk to who actually do think that their fees are going to go up because tax rates are going to go up for their managers.

I do find that scary. The irony is if you have conversations with leading people in the private equity world and in the hedge fund world, you will find very few people privately who would possibly agree with that argument. It is only the people they make it to publicly. Privately, they do not buy into that argument.

On the broader issue, one of the problems with one way the Committee might go in this area is obviously there are equity issues and there is a question, why am I supposed to treat private equity and hedge funds differently than I treat other classes.

On the other hand, if you basically said it looks and smells to me like compensation income, make it real simple, if I am a money manager at Fidelity, I pay ordinary income. If I am a money manager and I own the same stocks at Goldman Sachs, I pay ordinary income.

I actually own stocks. As a hedge fund manager, you know, then I get this capital gains benefit. There is an inequity and the obvi-

ous argument would be if you can extend it to other industries and get the votes together to do that, that would actually be more intellectually coherent.

Mr. TIBERI. Thank you.

Chairman RANGEL. You can make one Member of this Committee very happy if you share those views with his mother-in-law.

[Laughter.]

Mr. SILVER. Congressman, I think you made several important points. The first is it is not just a Wall Street issue. It is a Main Street issue. As you may know, we actually have an investment in a company in Columbus, Ohio. We also have investments in companies in Seattle, Golden, Colorado, RTP, Austin, Texas, and smaller communities scattered throughout the country, which do not typically see venture capital and which do not have any venture capital firms.

I think it would be fair to say that a number of those companies would not have been able to launch without venture capital.

The second observation that you made which I certainly concur with is that there is an artificial and intellectually incoherent inconsistency in selecting or identifying out a particular not just asset class but sector within the asset class.

We are looking at a snapshot today. If we were having this conversation in the late nineties, we might have been talking about venture capital. If we were talking about it in 2000, 2001, 2002, we might have been talking about hedge funds. If we are talking about it today, we are talking about mega buy out funds.

That is because there is a natural evolution and a natural ebb and flow within the financial industry and every industry. I do not know real estate as well, but I am certain there are ebbs and flows in the real estate industry, which also are a function of time and timing.

My strong concurrence with you is that we ought not to be in the business of trying to identify a subset of a subset of an asset class for particular tax identification issues.

Mr. IFSHIN. Congressman, to me, it comes across as you have to be careful of what unintended consequences emerge from something like H.R. 2834.

In 1986, when the Tax Reconciliation Act was passed, it ended up costing the Federal Government over $200 billion in the form of RTC and FDIC bail outs of S&Ls that went broke because they lent money to developers who had relied on the tax treatment that was removed.

Unintended consequences as it relates to this piece of legislation that I think are most important to consider are ones that would occur on the local level, as opposed to Federal tax receipts.

We bought an asset several years ago in your district. We are working to re-do that asset. If we succeed, one would assume that (a) we will create construction period jobs and we will ultimately lease that space to retailers who will create permanent jobs in what is the second largest Somali community in the world outside of Somalia.

It is a very, very challenged neighborhood and it is a challenging project. If we succeed, one logically assumes that the assessment on that property will go up, and the tax base in a neighborhood

that you well know has a shrinking tax base, will go up. Therefore, the homeowners in that community will face less of a relative increase in their property tax burdens than they would in the absence of our project.

We do this all over the country, not just in your district, Congressman. That is the impact that we have all over the country.

If you want to look at the average household income in that particular portion of your district——

Mr. TIBERI. I know it.

Mr. IFSHIN. I will tell you that the thing that is coming at your constituents is that their property tax bills are not going up one or 2 percent, they are going up 8 and 10 percent a year. Why? Because the tax base is shrinking. Their property taxes are becoming an ever growing percentage of their disposable income.

Chairman RANGEL. Mr. Doggett.

Mr. DOGGETT. Thank you very much for staying this late hour. We have been told really in this Committee for 12 years that our concerns about fairness and equity in the Tax Code and fiscal responsibility in the budget were inconsistent with competitiveness and with economic opportunity.

I think particularly your testimony, Mr. Hindery, just as with Mr. Shay earlier on international tax, suggests that is not true and there will be members of the business community who will come forward and say we have to have both, and that when a gross inequity exists, we need to correct it.

I do have some concern on the venture capital issue because I represent an area in which venture capital has been very important to the growth particularly of our small technology businesses. I gather Mr. Silver and Mr. Stanfill have worked in this area.

Are there not some distinctions, first of all, in the length of venture capital funds versus the length of time involved in the typical private equity fund?

Mr. STANFILL. You are talking about the timeframe?

Mr. DOGGETT. Is it usually 10 year funds?

Mr. STANFILL. There are 10 year funds. As a matter of fact, we will exit from an investment we made in 1995. There is no question that we spend a lot of time, sometimes decades or more, in bringing a company——

Mr. DOGGETT. I guess my first question to you, you feel there should be no distinction for venture capital from other types of equity funds, even though you are in the venture capital business?

Mr. STANFILL. That is correct.

Mr. DOGGETT. If that is the position that prevails ultimately, will there be a need for reasonable transition rules for funds that have already been formed, that have been going on for seven/eight/nine years and are now down to near the conclusion of the fund, where people relied on the old rules before you apply a new approach?

Mr. STANFILL. I think a grandfather provision might make sense in that case, Congressman.

Mr. DOGGETT. With reference to the role that venture capital funds play, Mr. Silver, versus other types of private equity funds, you commented on this to Mr. Rangel earlier, but do you find ven-

ture capital funds much more involved with the management of what are often start up or fairly new enterprises?

Mr. SILVER. Yes, Congressman. There are some substantial distinctions between various kinds of private equity funds. I leave it to my colleagues in the hedge fund and the private equity fund business, the buy out business, to describe their own activities.

The point I have been trying to make repeatedly this afternoon is that the role that the venture capital community plays is a co-founding/finance role. You are absolutely right in identifying longevity as one of the keys to that.

As Mr. Stanfill pointed out in his own experience, we are involved on a daily basis, for years and years, in growing these funds. Our first fund at Core Capital was launched in 1999. We made 23 investments in that fund. We have exited 14, or I should say only 14, in that time, and it will probably take us another 4 years to get out of all of the other transactions that we are in.

I should also say because I know Mr. Stanfill and I have different points of view on this, that I appreciate Mr. Stanfill's desire to address wealth and equality in this country, but I do think that the approach he is advocating is the wrong tool to address those concerns.

I actually think it endangers the structure that has supported innovation. The point I tried to make to an earlier question was that if the result of this tax disincentive is to incentivize venture capitalists to make investments in later stage companies, then almost by definition we will make fewer investments in early stage companies, create fewer jobs, and reap the penalty of that in economic growth.

Mr. DOGGETT. If the Committee does include venture capital with other types of equity funds on this whole matter, how do you believe that venture capital funds might reorganize to avoid that new law?

Mr. SILVER. I cannot answer the question as to how specifically they will reorganize, but I can assure you that every venture capital firm and every general partner in every venture capital firm will examine that issue closely.

Mr. DOGGETT. Mr. Stanfill.

Mr. STANFILL. I would only add if we do not start with our own house in terms of fairness, where do we start.

Mr. DOGGETT. Thank you very much.

Chairman RANGEL. From Texas asking the witnesses to identify the next loophole.

[Laughter.]

Mr. DOGGETT. I know there will be one.

Chairman RANGEL. Mr. Blumenauer. Thank you for your patience.

Mr. BLUMENAUER. Mr. Chairman, I must say that it is worth sitting through 10 hours of hearing today. I do not know that since I have been in Congress that I have sat through each of the panels and enjoyed them as much.

Particularly this panel, I have airplane reading for tomorrow going home. I will re-read each of the statements. I found them fascinating.

I personally do distinguish as it relates to real estate. I have been having these conversations at home with a variety of people who are in—we do not have a huge hedge fund. We have a little bit of activity. We have financial advisors. We have people involved with venture finance. We have lots of people who want venture investments.

I think this hearing, Mr. Chairman, might look a little different next year, given some of the froth that is going on in other aspects of financial markets. I wonder in terms of when we sort of squeeze out some of the problems we have seen with some investments and we look into some of the financial markets, if we might be having a slightly different take about priorities and what we want to do.

Putting that aside, I have noticed a tiny bit of difference from left to right here on the panel. I am just speaking as I am looking. I am very interested in getting reactions, I guess, in two areas from each of the panelists. I will try to be brief.

It was my impression that primarily this money followed the performance of investments, that if hedge funds or venture capital starts blowing up, people are going to go elsewhere. If people have goofy fee structures or there is more economic opportunity somewhere else, regardless of the tax structure, people are going to follow where there are good investments, and if there are not good investments, they are not going to be doing it, and pension funds and university endowments are not going to be throwing money at the people in question.

I was intrigued, Mr. Hindery, with your point that we did not see fee structures altered when there have been adjustments downward. It has been about 40 minutes since you said that. I would like to start to give you an opportunity to clarify, if you have changed your mind.

I would like to go down the line with folks in terms of is that a valid point, and second, I was concerned, Mr. Silver, you mentioned there are not enough qualified, talented professionals, that firms are declining, and it is hard to get good people. I am wondering is that because we are not paying them enough, there are not people in venture capital or in hedge funds that you cannot attract the best and the brightest?

If we could just go from left to right briefly, I would be interested in your observations or amendments.

Mr. HINDERY. Congressman, this is an awful good gig if you can get it. I just think all of this unintended consequence plow that has tried to be overhung on this industry today, it is an obfuscation. This is a good deal, Congressman. It really is.

I would simply ask my colleague, Mr. Rosenblum, why he did not adjust his rate down, if he is so anxious about the consequences to this entire industry, when there is the prospect of the rates on his personal level going up.

That inconsistency, I think, belies the strength of every one of the arguments that has been made at the far end of the table. There has been no rate adjustment in the six times——

Mr. BLUMENAUER. I am sorry. My time is fast going. I really do want to have people react to this. I think it is important.

Do you have trouble getting qualified people to work for you in the industry?

Mr. HINDERY. I have no problems at all; none. In fact, it is quite the opposite. There is no industry that is a richer environment than ours right now to attract people.

Mr. BLUMENAUER. Mr. Stanfill.

Mr. STANFILL. We have no problem filling slots. We are a very small firm. We are small potatoes, to tell you the truth. People seek us out. We do not have room for the people who come to see us.

Mr. BLUMENAUER. Do you see an issue here in terms of the relationship between capital gains going down and fee adjustments? Did you adjust your fees when capital gains went down?

Mr. STANFILL. We did not adjust our fees. However, the terms, the partnership terms, after the decline that the industry went through after the meltdown in 2000, all of a sudden it became a buyer's market instead of a seller's market. The terms that were negotiated were more in the investor's favor than they had been.

Mr. BLUMENAUER. Mr. Kramer.

Mr. KRAMER. Three decades ago when I did work in this town, actually, I did not know anyone who was talented who wanted to go into the asset management business. It just was not the thing. Now, the top people coming out of the top schools, they want to be in private equity. They want to be in hedge funds. Nobody thought that way then. There is not any question about where the talent is going.

In terms of tax rates and fees, that is not a subjective thing. That is empirically the case, historically. There is no relationship between what the tax rates were and what the fees had been. There is not some counter argument that somebody could make.

More broadly, today, the financial services industry is a record part of GDP. By the way, to throw more tax subsidies into it, you will get more of anything.

If at the margin some of the mathematically inclined did not go to hedge funds, in other words, if there was some diversion of talent away from what all of us do professionally, it is not clear to me that as a social matter, America would suffer if in fact our whole general area of enterprise was deemed less attractive.

I would also say just a general thing, and I think all of us think this way, if you have a pool of money, you have $1 million, you have $100 million, you are always thinking the same way, which is what is the most attractive risk-adjusted set of places that I can use to do with this money.

Actually, whether you tax me at a lower rate or you tax me at a higher rate, I am still going to be looking at the best risk-adjusted after-tax return that I can get, because I do not know how else to think about the $1 million.

Mr. SILVER. Congressman, I think it is very important that we not think of the financial services sector that we are discussing as monolithic. We have been very fortunate to attract very talented people to our firm, but it is not in fact easy to do that.

We have several hundred million under management, but we do not have billions and billions. If you do the math on a 2 percent management fee on several hundred million dollars and you subtract out rent escalators and legal fees and accounting fees and everything else, there is not there what you might think there is.

I would answer your question slightly differently and say yes, we are in a constant search for good talent because there are other places for prospective young venture capitalists to go, including within this sector, but the sector is not monolithic, and that is what causes that movement to occur.

You do not want to lose those people because what makes venture capitalists, successful venture capitalists unique, is an unusual combination of technology background and business building skills. That is hard to come by.

Mr. IFSHIN. Congressman, we have a terrible time attracting talent such to the point that we have actually started a training program for recent college graduates. The reason is that there is a huge draw of those people to Wall Street and what they pay.

As it relates to fees, we do not charge investment management fees. It is not applicable.

Mr. ROSENBLUM. Let me just say on this fee issue, I am not sure where Mr. Hindery gets his data, but I think it is important to have some data when you talk about this.

There has been a trend over the last 10 years in the private equity industry, certainly at our firm, to have lower fees as a percentage of capital under management. I do not think that you can fairly attribute that to any one particular factor, but I think taxes are part of the mix there.

Mr. BLUMENAUER. I will stop. I would like to request that be submitted in writing. I think it is a little different than what I heard. I do not want to debate it, but I would like it clarified in terms of percentage of assets under management, the fees, as opposed to the fees that are charged related to the tax. I just need help clarifying that. I heard two different things.

Thank you. Thank you for your patience.

Chairman RANGEL. Ms. Schwartz.

Ms. SCHWARTZ. Thank you, Mr. Chairman. Thank you for your patience and for the panel as well. As is sometimes said, if I am standing between you and dinner, I suppose I should be brief. I hope we are standing between you and dinner anyway. It is getting about that time.

I also think that today's hearing, and your panel in particular, really expresses a lot about what is great about America, the willingness to invest and take risks and support bright ideas and entrepreneurs and make money off that. That is part of what we do in this country. It is a good thing.

We are also looking at here, of course, how we can be fair about how we tax those winners, and I guess sometimes those losers.

Thank you for what you have done. I know some of you I have met with individually, and I appreciate that, and hopefully we will sort this out in a way that allows a continuation of investment in the brightest ideas.

One of the questions I asked the previous panel, I wanted to give you the opportunity to respond to as well, and it has to do with the concern about our public pensions. If you were here before, I mentioned that previously when I was a state senator in Pennsylvania, I authored the law that moved our retirement systems in Pennsylvania, both for the teachers and for public employees, to a prudent person standard from a legal list.

That created an enormous opportunity to invest in different ways and to get much better returns on those investments. Certainly those investment managers have made good profits off that, and I think much of that is fair.

There has been a scare put out. I think it was a good idea. It has worked out well, I think, for the pensions and for taxpayers in Pennsylvania and other states where we have done it.

The concern is if we make a change in the way we handle the taxation for the managers in terms of carried interest, that we will see a real change in not getting those kind of returns, that we will not see investment managers willing to do this, they will have to charge much higher fees, that it will disrupt what is working.

Mr. Kramer, I think I will start with you because you were very clear about the fact that would not happen, I think is what you said. The previous panel agreed with you, by the way. They said that would not happen. Most of the pension funds have said they did not believe that would happen.

I just want to give you the opportunity, Mr. Kramer, to re-affirm that, and then anyone else who wants to really disagree, that this change could really be damaging to the retired, the pensioner, in any of our districts, who are really worried about that, or our taxpayers who have also been very pleased not to see taxes go up for school districts in particular because it has worked.

We do not want to disrupt what works. Mr. Kramer, would you start, and then if anyone wants to disagree with you.

Do you think we will see a negative consequence?

Mr. KRAMER. Yesterday I agreed to join with your State Treasurer. She is putting together a group of seven people to initiate reforms on the investment side in Pennsylvania, and I will be part of that, helping your state.

Ms. SCHWARTZ. Thank you.

Mr. KRAMER. Two things. Number one, one of my erstwhile private equity friends called yesterday, why am I in this position. That is the world, alternative managers, that I come from socially. He wanted me to at least make the point that hedge funds and private equity are appropriate investments for pension systems, and actually, I have in fact strongly supported that view.

I went and took this particular assignment in New Jersey, because New Jersey had never done any of this stuff. They never used any outside managers. They never had a private equity investment. They never had real estate. They never had venture capital and they never had hedge funds.

I went there in order to change it. I do believe in the activity. I would simply say that what Congressman Tiberi expressed undoubtedly is true of the sentiment of some of the people on the pension side. I would not want to accuse anyone of public hypocrisy, but I have a lot of friends in the alternative management business, and it is difficult for me to find people in the alternative management business who actually believe that fees are automatically going to go up because the tax rates go up.

If basically the returns are great over the next 5 years, then people are going to be able to charge even more for what sort of everybody collectively does.

Ms. SCHWARTZ. Anyone else want to disagree with that? Mr. Rosenblum.

Mr. ROSENBLUM. I would say this is not a black and white issue and it is not consequences that are going to happen overnight or be uniform across different managers.

There clearly are investors who are concerned about it. Obviously, there are some who are not. I think the concerns are genuine and I think the economic likelihood is that pressured by additional costs, the firms that can extract something more are going to try to extract it. It will not be everybody. They will not be able to pass all the costs through.

I think you will see a shift over time, and I am very surprised that folks think they have the crystal ball that tells them that will not happen.

Ms. SCHWARTZ. Thank you.

Mr. HINDERY. Congresswoman, in the prior panel, if there is an absolute one to one correlation, I believe there is none, as seemingly does Mr. Kramer, I believe there is none, but in the prior panel, it was proffered to this Committee that if in fact it passed through, it would have a two basis point impact on the returns of the public investor community. That is if it is a 100 percent correlation, two basis points. That is my point.

Ms. SCHWARTZ. Let me thank you very much. I guess I would say my assumptions, one of the reasons we are spending the time that we are is because there will be consequences. There will be changes. There will be effects.

We want to make sure, as we often do, we have to make sure that the risks, as you do in the work you do, that the benefits outweigh the risks that we are taking in terms of the consequences, and that all of those really very smart people who work for you, and actually, we have a lot of smart people working for us as well, will figure it out so that we get the greatest benefit to Americans, both the taxpayers and the investors.

Thank you.

Chairman RANGEL. Let me thank this panel for its patience. I think Mr. Blumenauer said it. It certainly was illuminating listening to your testimony. I know no matter how many times I say it, it would appear as though we are targeting public/private investors, equity investors, or hedge fund operators.

I would just like to conclude by saying this Committee started these hearings with the sole purpose of seeing how we could eliminate the alternative minimum tax. We made it abundantly clear that where we saw in the Tax Code unfairness, something that did not encourage economic growth, that would be used as one source of revenues in order to compensate for the dramatic loss we would have in alternative taxes.

Orin Kramer knows I live in Harlem. I have not had an overwhelming number of constituents come to me because I said fairness and equity and they said you are taking something away from me.

There is no one here that can find anything that the Chair has said that would indicate that we are looking at these issues for the purpose of raising revenue.

I am amazed that fairness and equity as a guideline for this Committee has caused so much concern. Having said that, I would assume that you will have time to tell your constituents that there is a valid case made for the difference in the way people are taxed.

This Committee would like to hear it. This has been a great Committee. I want to give a special thanks for Orin Kramer because I know some of the people he associates with, and they are not going to be very nice to you tomorrow or the next day or the next day.

This has been illuminating. As we have said before, we hope that you may have time to come back and to clear up some things. If you read things in the paper that you believe that you wish you had time to talk about while you had this time with us, please feel free to share that with us. We want to make certain at the end of the day, we can have a bill that the people believe in.

You have been an extraordinary panel. I want to thank you so much for your patience and being with us at this very, very late hour.

Thank you. Before I adjourn the Committee, I ask unanimous consent that the statement submitted from Mayor Blumberg's office on the question of the expansion of the ITC be submitted in the record.

The Chair hears no objection.

[The document referred to follows:]

[INFORMATION NOT AVAILABLE AT THIS TIME]

Chairman RANGEL. I want to thank Mr. McCrery for his patience and being with us. The Committee will stand adjourned subject to the call of the Chair.

[Whereupon, at 7:30 p.m., the Committee was adjourned, subject to the call of the Chair.]

[Submissions for the record follow:]

Statement of American Prepaid Legal Services Institute

I am John R. Wachsmann, President of the American Prepaid Legal Services Institute. The American Prepaid Legal Services Institute (API) is a professional trade organization representing the legal services plan industry. Headquartered in Chicago, API is affiliated with the American Bar Association. Our membership includes the administrators, sponsors and provider attorneys for the largest and most developed legal services plans in the nation. The API is looked upon nationally as the primary voice for the legal services plan industry.

I offer this written testimony in support of employer-paid group legal services for working families. Employer-paid group legal services provide a vital safety net for middle-income families.

The hearing today deals with the economic challenges and inequities in the Tax Code facing America's working families. Committee Chairman Rangel noted in calling the hearing that "One of the fundamental duties of the Committee on Ways and Means is to conduct oversight of the Tax Code and ensure that our tax laws promote fairness and equity for America's working families."

One effective and inexpensive part of tax relief for working families should be the restoration of the tax exempt status of Employer-Paid Group Legal Services. This is targeted tax relief that works two ways:

- It reduces the tax burden on working families and businesses
- It seeks to prevent or amerliorate the consequences of calamitous events that without legal assistance can quickly snowball into disaster

For example, one of the economic challenges facing working families is surviving in an increasingly complex financial environment. Currently working families are in an extremely precarious economic position. A perfect storm of adjustable rate mort-

gage increases, credit card interest rate increases, layoffs and cutbacks have put many families on the edge of economic collapse. Many working families are living paycheck to paycheck with very little cushion in the event of illness or injury.

A single event, such as a divorce, job lay-off or illness that interrupts cash flow is enough to trigger defaults on mortgages, evictions or collection lawsuits. Now is the time when working families need access to the legal system, through employer-provided legal plans, to save their homes, deal with debt and keep their families intact.

Group legal plans help working Americans in financial distress. Plans provide preventative assistance with mortgage and refinancing document review, as well as advice on sub-prime loans and exotic financing instruments. Group legal plans help American families understand the economics of their mortgages to avoid entering into transactions likely to result in future defaults.

If a default has occurred, plans will review the documents for compliance with existing laws and advise on workouts that allow reinstatement of the mortgages. The result is not only saving the family's place to live, but safeguarding the family's primary investment.

Group legal plans also provide employees with low cost basic legal services, including assistance with the preparation of a will, probate, and domestic relations issues, such as child support collection. Other issues plans address are:

- Protecting spouses and children in the event of death
- Anticipating the need for long term care, as well as Medicare and Medicaid issues
- Informing medical professionals on how they want to be treated in the event of a serious illness or a life threatening accident
- Instructing family members on how they want their property handled in the event of incapacitating illness or accident
- Addressing financial management and investment issues in the face of a decreased income
- Educating clients on how to avoid identity theft and what steps to take if a client is a victim of this crime

Legal plans provide the advice and legal documents to accomplish these tasks through wills and trusts, powers of attorney, living wills/medical directives, guardianship and conservatorships, nursing home contract review, Medicare and Medicaid appeals and home refinancing document review.

Yet now, when the need is at its greatest, fewer Americans have access to inexpensive, preventative legal assistance. Since the loss of the benefit's tax-preferred status in 1992, existing plans have been forced to cut back and few new plans have been added.

As employers seek to limit expenses by reducing or eliminating benefits in general, targeting benefits that are not tax-preferred is high on employers' lists. Recently this trend toward reducing benefits has taken a toll on existing group legal plans. Large employers such as Rouge Steel, Delphi and Visteon have either dropped the benefit entirely or created a two-tier benefit system that eliminates group legal for their newest employees. The lack of a tax preference for group legal plans makes the benefit vulnerable for reduction or elimination by employers, effectively barring access to justice for millions of working Americans.

Section 120 was originally enacted in 1976 and extended on seven separate occasions between 1981 and 1991. This Congress has the opportunity to reinstate Section 120 of the Internal Revenue Code of 1986 and restore the exclusion from gross income for amounts received under qualified group legal services plans. This will provide an incentive for existing plans and tax relief for working families and businesses.

Bills have been offered in the past several Congresses, including this year's bill, H.R. 1840, introduced by Congressmen Stark and Camp and co-sponsored by 31 Members of Congress, 15 of whom are on the Ways and Means Committee. The identical Senate version of the bill, S. 1130, has similar bi-partisan support on the Finance Committee.

Reinstatement of the benefit's tax preference will provide direct and immediate tax relief to employees. When this exclusion expired, it triggered a tax increase for millions of working Americans whose employers contribute to such plans. Currently more than 2 million working families with legal plans offered by such national companies as Caterpillar, J.I. Case, Mack Truck, John Deere, Ford Motor Company, General Motors, and thousands of small businesses are taxed on the employer's contribution, whether or not they use the benefit.

Businesses will also gain direct and immediate tax relief. Employers must pay an additional 7.65 percent of every dollar devoted to a legal plan as part of its payroll

tax. Employees pay the payroll tax plus income tax on the cost of the benefit whether they use it or not in any given year.

Encouraging this benefit is also an efficient and low cost way of offering economic protection and education to middle class working families. Employers can provide a substantial legal service benefit to participants at a fraction of what medical and other benefit plans cost. For an average employer contribution of less than $100 annually, employees and retirees are able to take advantage of a wide range of legal services often worth hundreds and even thousands of dollars, which otherwise would be well beyond their means.

In conclusion, reinstating Section 120 would repeal a tax increase on middle class Americans and businesses and restore equity to the tax treatment of this benefit. Reinstatement will also insure access to the legal system for millions of middle-class families who might otherwise be priced out of our justice system. Restoring the tax-preferred status will demonstrate to millions of hard-working low and middle-income workers, not only that this Congress supports them, but that the Tax Code can be fair and equitable.

Statement of Chamber of Commerce

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]

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 U.S. 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

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[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 percent.

[4] Jensen, M.C., 1993, The modern industrial revolution, exit, and the failure of internal control systems,

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 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 second year after the buyout onwards. Companies which remained buyouts for ten or more years experienced substantial changes

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

[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.

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.

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 includ-

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[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.

[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).

ing 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.

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 ac-

[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.

complished satisfactorily, fund managers would have little problem avoiding the bulk of these new taxes by acquiring non-recourse loans from limited partners.

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 nonprofit 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 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.

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[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.).

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.

Statement of National Association of Publicly Traded Partnerships

The National Association of Publicly Traded Partnerships (NAPTP) is pleased to have this opportunity to submit a statement for the record with respect to the "Hearing on Fairness and Equity for America's Working Families" held by the Committee on Ways and Means on September 6, 2007. NAPTP, formerly the Coalition of Publicly Traded Partnerships, is a trade association representing publicly traded partnerships[1] (PTPs) and those who work with them. Our current membership includes sixty PTPs and thirty-five other companies.

PTPs are provided for under section 7704 of the Internal Revenue Code. This section generally provides that a very limited universe of companies—those engaged in active natural resource or real estate business as well as those generating passive investment income—can be publicly traded partnerships.

I. Publicly Traded Partnerships and Carried Interest

A primary focus of this hearing is the fact that certain private equity and hedge fund managers, among others, are compensated for their services via a "carried interest"—a partnership profits interest—and that this compensation is received and taxed as capital gains. Awareness of and concern about this practice escalated early this year when a few such funds went public as PTPs or expressed the intention of doing so. It is important to remember, however, that the ability of these managers to receive carried interest in the form of capital gains arises not because their companies are publicly traded partnerships—the vast majority are not—but because they are partnerships whose investments produce capital gain. The tax treatment of carried interest is based on long established rules of Subchapter K regarding the tax treatment of partnership interests received in return for services provided to the partnership, and not on the publicly traded partnership rules of section 7704.

Moreover, it is important to recognize that not all carried interests, nor all partnership profits interests, pass through capital gains to the holder of the interest. The rate at which the income from "carried interest" is taxed is dependent on (i) the organizational nature of the company receiving the carried interest (C corporation, partnership, etc.) and (ii) the character or nature of the underlying income. If the recipient is a C corporation, the income will be taxed at ordinary income tax rates. If it is a partnership, then it is not taxed at the entity level and the rate at which it is taxed is dependent on the nature of the income. The nature of the income received by the partner will depend upon the nature of the income generated by the business. Typically, the private equity funds receive the bulk of their income when they sell the companies in which they invest, and the proceeds from a sale are usu-

[1] Publicly traded partnerships are also referred to as "master limited partnerships" or MLPs.

ally characterized as long-term capital gains. In contrast, the business of "traditional" PTPs, i.e., those PTPs clearly and purposefully treated as partnerships in 1987, generates ordinary income.

The general partners of many PTPs (ten of which are themselves PTPs) have profits interests known as an incentive distribution rights (IDRs), under which the general partner receives a 2 percent interest in the PTP's income. This percentage share increases in steps as distributions to the limited partners reach target levels. This profits interest, however, gives rise to ordinary business income and is taxed as such in the hands of the general partner.

While private equity firms are not part of NAPTP, we take no position on whether the carried interest rules for investment partnerships should be changed. However, as an association that was organized in the 1980s when the tax treatment of PTPs was a subject of debate, and which played a role in the enactment of the current law that preserves partnership treatment for certain PTPs, NAPTP is happy to provide its perspective on the history and intent of section 7704 and to provide information on the PTPs that we represent.

As we do so, we strongly urge that Congress avoid changing the law that for two decades has governed the "traditional" PTPs. Those PTPs operating in the energy industry in particular are a long-established segment of that industry and play an important role in the development of the national energy infrastructure needed to insure our continued economic growth and security. This role is widely recognized by observers ranging from FERC to energy analysts on Wall Street. There is no policy reason to overturn twenty years of settled and successful tax law by changing the tax treatment of these traditional PTPs.

II. Early History of PTPs

The first publicly traded partnership was Apache Petroleum Company, which was created in 1981 by Apache Oil through the roll-up of several smaller partnerships. It was soon followed by a number of oil and gas exploration and production PTPs as well as by real estate PTPs. Some, like Apache, were formed by partnership roll-ups; some by spin-offs of corporate assets; some (until the Tax Reform Act of 1986 repealed the General Utilities doctrine) through corporate liquidations; and a few through IPOs for new business operations.

The energy and real estate industries had traditionally used limited partnerships as a means of raising capital and conducting operations. The pass-through structure of partnerships allowed investors to share directly in both the profits and the tax attributes of these industries. Traditional limited partnerships, however, could attract only a limited pool of investors. They required investors to commit large amounts of money and were very illiquid. Thus, only very affluent investors could afford to participate.

By dividing partnership interests into thousands or tens of thousands of units which were affordably priced and could be traded on public exchanges, PTPs were able attract a far broader range of investors than private limited partnerships, providing a new flow of equity capital to the energy and real estate industries. Unlike many of the limited partnerships that were formed during the 1980s as tax shelters aimed at providing investors with a tax loss, PTPs were created to be income-generating investments. Companies with energy, real estate, or other assets providing positive income streams over a number of years were able to attract investors seeking steady cash distributions.

As the 1980s progressed, PTPs began to emerge in other industries, e.g., the Boston Celtics and the Cedar Fair amusement park company. This became a source of concern to tax policymakers.

A. Development of the 1987 Legislation

Until 1987 there were no provisions in the Internal Revenue Code specifically addressing publicly traded partnerships. However, the growth of PTPs led to fears on the part of the Treasury Department and some Congressional policymakers that the expansion of PTPs would cause a substantial loss of corporate tax revenue. In addition, the 1980s were the decade of tax reform, and some felt as a policy matter that the fact that public trading of securities was an inherently corporate characteristic—an idea with which we have always disagreed.[2]

After several years of debate over the issue of whether large and/or publicly traded partnerships should continue to receive pass-through tax treatment, the Treasury Department and Congressional tax writers determined to address the issue in 1987. It was clear from the beginning that while there were varying views on the degree to which PTPs should be restricted, there was considerable support for the idea that

[2] The vast majority of corporations are never publicly traded.

the natural resources industry, which had always raised capital through partnerships, should continue to be able to do so through PTPs.

Hearings on publicly traded partnerships were held by this Committee on June 30 and July 1, 1987, and by the Senate Finance Subcommittee on Taxation and Debt Management on July 21, 1987. At both the House and Senate hearings, Assistant Treasury Secretary for Tax Policy J. Roger Mentz, one of the primary advocates of restricting the use of PTPs, testified that partnership tax treatment should be retained for PTPs engaged in natural resources development:

If Congress changes the classification of MLPs for tax purposes, we suggest that it consider extending the current statutory pass-through models to include activities such as natural resource development. Thus, as with REITs, RICs, and REMICs, entities engaged principally in developing timber, coal, oil, and gas, and other natural resources serve a relatively passive function, generating income from wasting assets and distributing it to investors. Given the importance of natural resource development in the nation's security, Congress should consider carefully whether such traditionally noncorporate activities should be subjected to corporate level tax. . . . [Emphasis added]

B. Final Legislation

The provisions that we now know as section 7704 of the Code, which were enacted as part of the Revenue Act of 1987, originated in this Committee. This Committee retained partnership tax treatment for PTPs generating the type of income, such as interest and dividends, that one would receive as a passive investor, explaining in its report,

If the publicly traded partnership's income is from sources that are commonly considered to be passive investments, then there is less reason to treat the publicly traded partnership as a corporation, either because investors could earn such income directly (e.g., interest income), or because it is already subject to corporate-level tax (in the case of dividends). Therefore, under the bill, an exception is provided . . . in the case of partnerships whose income is principally from passive-type investments.

This Committee did not allow interest to be treated as qualifying income if it was earned in conducting a financial or insurance business, "as deriving interest is an integral part of the active conduct of the business." Dividends, unlike interest, were not specifically restricted in the statutory language, but this Committee's report states, "Similarly, it is not intended that dividend income derived in the ordinary conduct of a business in which dividend income is an integral part (e.g., a securities broker/dealer) be treated as passive-type income."

Importantly, this Committee also retained partnership tax treatment for PTPs engaged in two types of active businesses: real estate and natural resource activities, noting in its report that these activities "have commonly or typically been conducted in partnership form" and that it "considers it inappropriate to subject net income from such activities to the two-level corporate tax regime to the extent the activities are conducted in forms that permit a single level of tax under present law." Natural resources activities were purposely defined very broadly to include "income and gains from exploration, development, mining or production, refining, transportation (including through pipelines transporting gas, oil or products thereof), or marketing of, any mineral or natural resource, including geothermal energy and timber."[3] This is essentially the rule that Congress adopted in the final bill.

In summary, Congress' intent in 1987 was to allow partnership tax treatment for PTPs generating investment-type income, i.e., income such as interest and dividends which a passive investor might earn without directly participating in a business. Partnership tax treatment for active business operations was also allowed to continue for two industries which had traditionally used the partnership structure, real estate and natural resources. Importantly, however, the evidence is that Congress also intended that qualifying income should include dividends received by PTPs from taxpaying corporate subsidiaries.

C. Non-Qualifying Income and Corporate Subsidiaries

As noted above, while the legislative history of section 7704 clearly indicated that interest and dividends earned as part of a financial business should not be considered to be qualifying income, it did not state or imply that dividends from corporate subsidiaries of PTPs would not be qualifying income to the PTP. To the contrary, it is apparent that Congress condoned the use of corporate subsidiaries.

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[3] "In the case of natural resources activities, special considerations apply. Thus passive-type income from such activities is considerably broader. . . ."

The 1987 Treasury testimony noted above, which suggested that partnership tax treatment be retained for entities engaged principally in developing natural resources, also acknowledged that if this exception was enacted into law, many "downstream" operations such as milling, processing, refining, or marketing activities would remain in corporate form. Thus Congress was aware of the potential use of corporate subsidiaries for this purpose and did not exclude or restrict dividends from such subsidiaries as qualifying income in enacting section 7704.

In addition, as the legislative history makes clear, section 7704 was resulted from the concern that the widespread use of PTPs would lead to a loss of corporate income tax revenue. Thus, there could be no objection to a PTP receiving dividend income from a subsidiary earning non-qualifying income that had been subject to corporate tax. Finally, the transition rules provided by Congress for existing PTPs with non-qualifying income allowed them to remain in existence after the transition period ended if they were able to change their income stream to meet the qualifying income test of 7704, and placed no restrictions on PTPs' ability to place operations in corporate subsidiaries for this purpose.

Some NAPTP members form corporate subsidiaries for related activities that generate non-qualifying income.[4] This is done to ensure that the qualifying income test is met. Although the amounts involved are usually quite small, it is important to remember that the penalty for exceeding the 10 percent limit on non-qualifying income is extremely severe—the conversion of the PTP into a corporation, with resulting adverse tax consequences to the company and its investors. We therefore feel it is entirely appropriate to use a corporate subsidiary, which is not afforded flow-through treatment, to act as a "safety valve" for the qualifying income test.

Since 1987 no additional restrictions have been placed on the activities of publicly traded partnerships and there have been some small liberalizations in their tax treatment. For example, in 1993 the rule enacted in 1987 which treated all income from a PTP as unrelated business income for tax-exempt investors, regardless of the nature of the income, was repealed; and in 2004, with bipartisan support, Congress added PTPs to the list of qualifying income sources for mutual funds.

III. PTPs Today

A. PTP Businesses

The PTP universe today looks very different from the one in 1987. Most of the PTPs doing business in 1987 are gone, eliminated not by Congress, but by the marketplace. Changes in economic conditions for the energy and real estate industries in the latter part of the 1980s led to a wholesale change in the composition of the PTP universe.

Gradually over the course of the 1990s and early 2000s, the exploration and production PTPs were replaced by companies in the "midstream" sector of the energy business: pipeline and marine transportation, processing, refining, gathering, marketing, etc. This sector is much less affected by oil and gas prices, receiving a contracted fee for services regardless of the price of the commodity, and thus is better able to maintain steady distributions through the ups and downs of the markets. Companies with these types of assets, particularly regulated pipelines, found that they were able to attract more capital in PTP form than in corporate form.

Today, by the Association's count, there are some 80 publicly traded partnerships trading on the major exchanges, including the Fortress and Blackstone entities. The great majority of these are energy-related partnerships, as demonstrated in Table 1. The total market capital of these 80 PTPs is about $163 billion as of August 31, of which about $134 billion or 82 percent comes from the energy-related sectors.

Table 1
Publicly Traded Partnerships on Major Exchanges

	Number*	Percent of Total	Market Capital ($B)	Percent of Total
Oil and Gas Midstream Operations	39	48.8%	$91.7	56.2%
Marine Transportation	6	7.5%	$3.8	2.3%
Propane & Heating Oil	9	11.3%	$23.6	14.4%
Oil & Gas E&P	7	8.8%	$7.6	4.6%

[4] Some members also have corporate subsidiaries which generate qualifying income, as part of an acquisition or joint venture, or for other reasons.

Table 1
Publicly Traded Partnerships on Major Exchanges

Coal	5	6.3%	$7.4	4.5%
All Energy	**65**	**82.3%**	**$134.0**	**82.2%**
Other Minerals, Timber	2	2.5%	$2.2	1.4%
Real Estate—Income Properties	3	3.8%	$8.5	5.2%
Real Estate—Mortgage Securities	3	3.8%	$1.8	1.1%
Miscellaneous	6	7.5%	$16.5	10.1%
All PTPs	**80**	**100%**	**$163.0**	**100.0%**

ANumbers include 10 PTPs which are publicly traded general partners of other PTPs. This includes 6 in Midstream Operations, 2 in Propane & Heating Oil, and 2 in Coal.

B. PTPs in the Energy Industry

Of the various sectors of the energy industry in which PTPs operate, the largest by far, representing over half of the PTP market capital, is the midstream sector: PTPs which gather oil and natural gas in gathering pipelines; compress natural gas for transportation; refine or process crude oil and natural gas into natural gas liquids; fuels, and other products; transport oil, gas, and refined products in intra- and interstate transmission pipeline systems; and store them in terminals. Another group of PTPs, currently six in number, transports petroleum products by water to areas not reached by pipelines.

In other energy niches, several PTPs are engaged in the distribution of heating oil and propane. In addition, seven to date have returned to the place where PTPs originally started—exploration and production of oil and gas. For various reasons, these PTPs are considered by analysts to be more conservative and less risky than their 1980s counterparts. Finally, three PTPs and two PTP general partners are in the coal industry; one engaged in active production; the others as lessors of coal reserves.

As midstream energy operations have become an increasingly important part of the businesses conducted by PTPs, PTPs have conversely become an increasingly important part of the midstream energy industry, and particularly the ownership and operation of oil and gas pipelines. As shown below in Figures 1 and 2, the midstream energy PTPs dominate the PTP world in both numbers and market capital.

MISSING GRAPHICS

Why has so much midstream energy capital moved into PTPs? Over the past decade, many corporate energy companies have realized that they had a good deal of capital tied up in pipeline assets which, although dependable generators of cash, produce only a modest return, particularly for those pipelines subject to rate regulation. By selling these assets to PTPs, they could monetize them and reinvest the capital in areas closer to their core business and with higher returns. PTP unitholders, meanwhile, would receive the benefit of the steady cash distributions generated by pipeline fees.

PTPs, for their part, have proven to be a highly efficient means of raising and investing capital in pipeline systems. Their structure affords such PTPs a lower cost of capital, allowing them to spend more on building or acquiring pipelines. PTPs need to pay out most of their earnings as cash distributions due to their pass-through tax status, which requires the unitholders to pay tax on their shares of partnership income regardless of whether they receive a corresponding amount in cash; therefore, PTPs cannot retain earnings for building or acquiring pipelines and other assets. The need to go to the equity or credit markets to raise capital lends discipline to their capital expenditures, helping to ensure the most efficient use of capital.

For these reasons, the proportion of oil and gas pipelines owned by MLPs has steadily increased over the years. We estimate that PTPs today own over 200,000 miles of pipelines—gathering and transmission, onshore and offshore, carrying natural gas, natural gas liquids, crude oil, and refined products, as shown in Table 2. Of the $163 million of PTP market capital, $102 million is in pipeline PTPs. To an

increasing extent, PTPs are building and maintaining the pipeline infrastructure on which we depend for energy security.

Table 2
PTP-Owned Pipeline Mileage as of August 2007

	PTP-Owned Mileage (1)
Crude Oil	29,496
Refined Petroleum Products	37,527
Natural Gas	123,942
Natural Gas Liquids (3)	20,641
TOTAL	211,606

(1) Sources: PTP 10–Ks and websites. When a PTP owns a partial interest in a pipeline, the mileage included is equal to (pipeline miles) x (percentage interest).

This fact has been increasingly recognized by, among others, the Federal Energy Regulatory Commission (FERC), which oversees a number of pipelines owned and operated by PTPs. Most recently, on July 19, 2007, FERC Chairman Kelliher issued a policy statement stating that PTPs will henceforth be included in the proxy group for calculation of returns under the discounted cash flow model for natural gas pipelines. Kelliher noted that PTPs have been included in oil pipeline proxy groups for a number of years due to the lack of corporate owners and stated:

The reality is that both sectors have increasingly adopted the MLP structure as the framework for the pipeline business. This raises a policy question: have we reached a tipping point, have we reached the point where the natural gas pipeline sector has adopted the MLP to such an extent that it is perverse to exclude MLPs from the proxy group? In my view we have reached that point. It seems clear we reached that point with respect to oil pipelines some time ago.

It was in recognition of this fact that the Senate Finance Committee this year included in its energy tax provisions a measure that would include transportation and storage of blended ethanol, biodiesel, and other renewable fuels in the definition of "natural resource activities" under section 7704. If the Federal policy of dramatically increased use of these fuels is to be achieved, pipelines will have to be built or converted to carry them. The past decade has shown that if large amounts of capital are to be put into pipelines, it will be PTPs that will do it.

The energy PTPs are doing exactly what Congress intended them to do in 1987, including building and maintaining the pipeline infrastructure on which we depend for energy security. Accordingly, the PTP provisions are working well and should be allowed to continue doing so.

IV. Conclusion

Twenty years ago Congress and the Treasury Department undertook a lengthy and careful consideration of the issue of publicly traded partnerships and who should have access to this particular business structure. The result was the enactment of section 7704 of the Tax Code. It is clear from the legislative history that those in Congress and the Executive Branch who participated in the development of section 7704 intended that—

- Activities generating passive investment income such as interest and dividends should be able to use publicly traded partnerships. However, companies for whom interest and dividends were their business income, such as those in the financial services industry, should not qualify as PTPs.
- Two types of active businesses, natural resources and real estate, which had traditionally raised capital through partnerships and whose existence was important to the national economy, should continue to be able to access the capital markets in partnership form.
- As long it is not "business" income to a PTP, dividend income, including income received from a corporate subsidiary, is qualifying income.

Over the ensuing years, the economics of the midstream energy transportation and storage industry and the interest of many integrated energy companies in finding more lucrative investments for their capital, have led to an increasingly important role for PTPs in this sector. The PTP rules have worked well in allowing capital to be channeled into the infrastructure needed to move traditional energy sources out of the ground, process them into useable products, and transport them from production areas to the areas where they are consumed. As the country moves to alternative forms of energy, PTPs will continue to play a central role. The ongoing debate on the pros and cons of carried interest should not be allowed to change this fact.

Statement of National Center for Policy Analysis

Mr. Chairman and Members of the Committee, thank you for this opportunity to submit testimony on methods to achieve a fair and equitable tax system. My testimony draws heavily from research conducted by scholars at the National Center for Policy Analysis (NCPA), particularly from NCPA Brief Analysis numbers 537, 571, and 588—all of which can be found at the ncpa.org website.

The Alternative Minimum Tax (AMT) enacted in 1978 was intended to tax the small number of wealthy individuals who, in any given year, legally owe no personal income tax due to the many exemptions allowed by the U.S. Tax Code. The AMT has its own set of rules, which limit deductions. Individuals with incomes above a certain level calculate their taxes under both sets of rules and pay whichever amount is higher.

However, the exemption levels are not indexed for inflation. Thus, as incomes have risen, more and more middle-class Americans have been forced to pay the AMT. Congress has addressed this problem by passing a series of temporary increases in the exempt amount, but when these temporary fixes expire, millions of middle-income citizens will be forced to pay a tax intended only for the super-rich. Rather than creating another temporary fix, Congress should use this opportunity to permanently restructure the tax system.

Problems with the AMT

In addition to the burden that awaits middle-class families when the AMT extensions expire, there are other problems.

Uncertainty for Taxpayers. By continuously setting back the date when the 2000 exemption levels return, legislators create uncertainty in the economy. In any given year, if Congress cannot agree on legislation to temporarily extend higher exemption levels, the middle class will be hit by the AMT. Furthermore, should Congress allow a return to 2000 exemption levels, the complexity of the AMT creates uncertainty for individual tax filers as to how they will be affected. Thus, even in the years when Congress is successful in extending higher exemptions, middle-class taxpayers may reduce their investments in order to protect themselves against a possible future rollback.

Future Dependence. Because of the growing number of taxpayers filing the AMT every year, the Federal budget will increasingly depend on it for tax revenue. Though repealing the AMT will cost an average of $74.5 billion annually over the next decade, if it remains in place, the costs increase over time. Every year, over two million more taxpayers will file AMT. By 2008, the AMT will be more expensive to repeal than the income tax—$100 billion versus $72 billion—according to the Tax Policy Center.

Unfairness. Currently, the AMT taxes individuals a flat 26 percent of gross income minus deductions for mortgage interest and charitable contributions. Therefore, the brunt of the AMT falls on taxpayers earning between $200,000 and $500,000. This is because they are most likely to fall under the AMT, but have lower mortgage interest and charitable deductions than higher-income taxpayers. While 43.4 percent of these individuals filed AMT in 2005, only 26.4 percent of taxpayers with incomes of more than $1,000,000 did, according to the Tax Policy Center. Ironically, the AMT does not achieve its original goal. Even with the AMT, 5,650 tax filers with incomes over $200,000 owed no income taxes in 2002.

The Regular Income Tax versus the AMT

In the 1970s and 1980s, supply-side economists and journalists noted that high marginal tax rates create a large "tax wedge" between the after-tax income workers receive and the value society places on their output—and between the after-tax return on investment and the value of the production that investment makes possible. A big tax wedge, and high marginal tax rates, stunt economic growth by discouraging work and investment. For a given amount of tax revenue raised, the lower the marginal tax rate the better.

The supply-siders' insight wasn't novel. In the United Kingdom, the top marginal tax rate in the 1970s was 83 percent on earned income and 98 percent on interest and dividends. James Mirrlees, a "left-wing" economist and Labour Party adviser, concluded that the optimal top marginal tax rate was only about 20 percent and that rates for other income groups should be close to 20 percent. An optimal tax rate would generate substantial government revenue while not greatly reducing individual incentives to work and invest.

In other words, Mirrlees provided an economic rationale for a "flat tax," such as an income tax that imposes the same rate at all income levels. Although such a re-

form is desirable, the odds that such a flat rate will ever be implemented are small. But it is possible to get much of the way there by flattening the AMT.

The AMT versus a Flat Tax

Most flat tax advocates want a zero percent tax rate on a minimum level of income and a tax rate of about 19 percent on all additional income, with few, if any, deductions allowed. The current AMT differs from this flat tax system in three main ways: (1) The basic exemption is higher, (2) the marginal tax rates are substantially higher, and (3) the expenses that are deductible are more numerous than under a flat-tax regime. All three aspects of the AMT could be modified easily, while raising the same amount of revenue for the Federal Government.

MISSING GRAPHIC

Under the AMT, instead of basic deductions, the first $45,000 of income is exempt for a married couple filing jointly. The tax rate on this income is zero. As the figure shows:

- On income above $45,000 the marginal tax rate is 26 percent, up to $150,000.
- Above $150,000 the marginal tax rate is 32.5 percent up to $206,000.
- Above $206,000 the marginal rate is 35 percent up to $330,000.
- Above $330,000 the marginal tax rate falls to 28 percent.

Although the IRS publishes AMT tax rates of 26 percent and 28 percent, in practice there are 4 rates since the exemption on the first $45,000 is phased out at higher income levels. After the exemption is completely phased out, the rate falls back to 28 percent.

AMT reformers usually advocate raising the amount of income that is exempted, which has been done in past years. Instead, Congress could *reduce* the exemption, further limit deductions and cut the AMT marginal tax rate to 24 percent, or even 20 percent. As recently as 1986, the AMT marginal tax rate was 20 percent. (The 1986 Tax Reform Act raised the marginal AMT rate to 21 percent, the 1990 tax bill raised it to 24 percent and the 1993 tax bill imposed the current nominal rates of 26 percent and 28 percent.)

Is a Flat Tax-Rate Desirable?

As supply-siders have emphasized, a low flat tax-rate has a positive effect on the incentives to earn, save, invest and become more productive, whether through training, education or experience. The lower the marginal rate, the stronger the incentives.

Critics of supply-side economics have admitted that the marginal dollars taxpayers are allowed to keep are an incentive to earn more income. But they also argue that since cuts in tax rates make taxpayers better off, they may use this higher real income to "buy" leisure—that is, work less. But this criticism warrants little attention unless the choice to work less resulted in less government revenue. Instead, the tax system could be changed to keep the Federal Government's revenues constant by reducing AMT deductions in exchange for lower marginal tax rates. In economics jargon, the system could be changed so that there is a substitution effect (working harder in response to higher after-tax incentives), but no income effect (that is, working less hard because of the tax break on nonmarginal dollars). The net effect would be more work and more output.

Long-Term Solutions: Flat Tax or Consumption Tax

As it is currently imposed, the AMT is complex and ineffective in ensuring that the wealthy pay taxes on their incomes. But even if it were repealed this year (while leaving the rest of the income tax system in place), by 2010, over 9,000 high-income filers would pay zero income tax, due to exemptions.

Congress should create a system that taxes everyone fairly and efficiently, and simplifies the entire Federal Tax Code. One solution is to replace the bloated, complex income tax system with a flat income tax. Another, purer, solution would be to implement a national sales or consumption tax.

A Lower Rate Flat Tax

A lower-rate flat tax can be structured in a way that:

- Ensures the rich continue to bear more of the burden than they currently do; thus, the plan can be more progressive than the current system.
- Taxes income only once (when it is earned), and does not tax savings or investments; thus, the plan promotes efficiency and economic growth.
- Does more to help low-income families by providing incentives to purchase health insurance and invest for retirement.

Steve Forbes has proposed a flat rate of 17 percent, with generous personal exemptions for all families, so that a family of four would not pay taxes until its income exceeded $46,000. Moreover, the Forbes plan encourages growth by exempting income that is saved and invested. Which means that the Forbes plan approximates a consumption tax. It taxes people based on what they take out of the economy, not on what they put in. It is a good plan, but can be improved upon.

The tax rate can be lowered further—14 percent as opposed to 17 percent—and at the same time do more to help low-income people. With the assistance of Boston University economist Laurence Kotlikoff, an advocate of a national retail sales tax, the NCPA put together a plan that works in the following way.

First, it would eliminate the across-the-board $9,000-per-person exemption in the Forbes plan. Why should billionaires like Bill Gates get an exemption? Forbes' plan gives too much money away to rich people. Eliminating the across-the-board exemption would allow the money to be rebated to the bottom third of earners, those who bring home roughly less than $25,000 for a family of four.

Second, Forbes doesn't address the 12.4 percent Social Security payroll tax (split between employer and employee), although the payroll tax is an example of a pure flat tax. Currently, income over $90,000 a year is not subject to the tax. It is a regressive feature of the current tax system that a $50,000-a-year autoworker has to pay payroll taxes on all his income while a million-dollar-a-year auto executive does not. Under the NCPA proposal, the income ceiling would be lifted and all wages would face the same income and payroll tax rates.

These changes should make a flat tax plan more politically appealing. Politicians are unlikely to adopt a new system that taxes the paychecks of the rich at a lower rate than those of blue-collar workers. Under the NCPA proposal, all wages would face the same income and payroll tax rates. And they would be taxed only once. All savings would accumulate tax free and be taxed only when withdrawn.

A More Progressive Flat Tax

This plan allows a lower flat-tax rate and produces results that should appeal to liberals as well as conservatives. What conservatives most want is an uncomplicated system that taxes income only once (when it is earned) at one low rate. Liberals are more concerned about progressivity. They want the rich to bear more of a burden than the poor.

The left objects to most consumption tax proposals because they mistakenly believe they aren't progressive. Low- and middle-income people would pay a greater share of what they earn than rich people. This proposed system is more progressive than the Forbes flat tax. It's also more progressive than the current system. Using economic modeling, Kotlikoff found that under the NCPA flat tax the rich would bear more of the burden than they currently do.

Health Care and Pensions

Most flat-tax proposals ignore health insurance and retirement saving. Yet the failure to insure or save—especially for low-income families—is a social problem. For that reason, the rebate of tax dollars to the bottom third of taxpayers would be used to help solve these problems. For example, as a condition of receiving the 14 percent rebate, low-income families would be required to show they have health insurance and a retirement pension. Specifically, to get one-half the rebate (7 percent), they would have to produce proof of health insurance. This would encourage millions of people who qualify to enroll in Medicaid or in their employer's health plan. Barring that, families could apply the tax rebate to health insurance they purchase on their own. The other half (7 percent) of the rebate would be contingent on proof of a pension, an IRA, a 401(k) or some other savings account. So instead of national health insurance and more government spending on the elderly, this flat-tax proposal would encourage people to solve these problems on their own.

A Higher Rate of Economic Growth

GRAPHIC MISSING

The tax system itself drags down the economy with the cost of keeping mountains of records and filling out voluminous forms. It also distorts economic decisions—everything from whether a spouse works to how much families save. The U.S. Government Accountability Office recently published estimates of these economic costs by various researchers. They found the efficiency cost of the tax system—the output lost over and above the amount of taxes collected—is 2 percent to 5 percent of gross domestic product. [See the figure.] In short, we lose between $240 billion and $600 billion every year just collecting taxes.

A post-card-sized tax return would slash compliance costs. A single tax rate applied to all wages would make the system more equitable and transparent. By im-

proving economic efficiency, it would raise productivity and hence the rate of economic growth.

National Consumption Tax—The Fair Tax

Another innovative tax reform proposal that deserves consideration is the national sales or national consumption tax, more recently called the Fair Tax. The Fair Tax would build on these fundamentals of taxation:

- Only people pay taxes.
- Consumption tax rates are self-limiting.
- Uniformity of taxation wards off special interest manipulation.

As described at fairtax.org, the Fair Tax proposal would replace all Federal income and payroll taxes with a progressive national retail sales tax. The Fair Tax would also incorporate a tax credit to ensure no Federal taxes are paid on spending up to the Federal poverty level. The Fair Tax would replace Federal personal and corporate income taxes, gift, estate, capital gains, AMT, Social Security, Medicare, and self-employment taxes and it would be administered primarily by existing state sales tax authorities.

Based on work done by Boston University economist Laurence Kotlikoff and Beacon Hill Institute, a Fair Tax rate of $0.23 out of every retail dollar spent on new goods or services would generate Federal tax revenues of approximately $2.6 trillion—about $350 billion more than the revenues generated by the taxes it would repeal. The Fair Tax would likely lower the lifetime tax burden for most Americans and would greatly simplify Federal tax compliance. The Fair Tax would also obviate the need for the Internal Revenue Service.

Conclusion

The AMT has not achieved its intended goals. It is inefficient because it discourages investment. At the same time, the AMT is ineffective in taxing the super-rich. Left unabated, it will cause a major tax increase for middle income filers starting in 2007. Congress could use this problem as an opportunity for restructuring the Federal Tax Code.

Both the flat tax and the consumption tax are big improvements over the current mess. A low-rate flat tax would help the economy. A rebate to the poor would enhance progressivity. Making the rebate contingent on the purchase of health care and saving for retirement will improve the quality of life. A national consumption tax—with a provision exempting spending up to the Federal poverty level—would dramatically shrink the costs of tax compliance and would promote an efficient, transparent means for Federal revenue generation.

President Bush said that he wants to reshape our tax system. Many in Congress agree on the need for change. But an oft-repeated objection is that tax reform benefits high-income taxpayers at the expense of low-income taxpayers. With the ideas presented here, that objection need not apply.

Statement of National Taxpayers Union, Alexandria, Virginia

Introduction

Chairman Rangel and distinguished Members of the Committee, thank you for the opportunity to submit written comments on behalf of the American Taxpayer regarding the important issues of tax fairness and tax equity. My name is Andrew Moylan, and I am Government Affairs Manager for the National Taxpayers Union (NTU), a non-partisan citizen group founded in 1969 to work for lower taxes and smaller government at all levels. NTU is America's oldest and largest non-profit grassroots taxpayer organization, with 362,000 members nationwide.

I write to offer our comments on the issue of tax fairness in private equity and the Alternative Minimum Tax (AMT). Few citizen groups in Washington can match NTU's 38-year history of participation in the national debate over tax fairness and simplification. We have established a principled stance in favor of lower, simpler taxes on all individuals and businesses, not just those who are politically in fashion at a given moment. You can find further research into these topics on our website at www.ntu.org.

Any discussion of tax fairness ought to begin with some context, by examining IRS data. Tax returns filed in 2005 indicate that on the same dollar, the wealthiest 1 percent of Americans paid an effective income tax rate nearly eight times higher than those in the bottom 50 percent. This picture does not change significantly even when taxes often thought of as "regressive" are included in the analysis.

A December 2005 study by the Congressional Budget Office (CBO) provides some illuminating statistics to prove the point. It accounted for ALL Federal taxes, including income, payroll, and social insurance taxes, and broke the burden down by income quintile. CBO found that Americans in the lowest income quintile (who made an average of $14,800) paid 4.8 percent of their income in ALL Federal taxes. Meanwhile, the highest quintile (situated at an average of $184,500) paid 25.0 percent of their income in taxes. Additionally, the top 1 percent of all income earners (who bring in an average of more than $1,000,000) pay 31.4 percent off the top in taxes.

This is hardly the picture of a Tax Code that is insufficiently progressive. The richest among us pay the most in taxes, in both absolute and relative terms. Yet, in spite of that fact, some Members of Congress persist in poisoning the tax policy debate with false rhetoric about the Tax Code being tilted toward the wealthy.

Private Equity Taxation

In the rush to find "pay-fors" to fund other priorities, some in Congress are now eyeing so-called "carried interest" taxes on private equity managers to raise additional revenue. These managers are compensated using the "2-and-20" method, which means that they get a salary worth 2 percent of the fund's assets and receive 20 percent of any capital gains the fund earns (also known as carried interest). If the fund suffers a loss, its manager receives nothing from the "20" portion and is compensated solely by the 2 percent portion.

That 2 percent is taxed at normal income rates while, under current law, the "20" component is taxed at the capital gains rate of 15 percent. One proposal, H.R. 2834 introduced by Representative Levin (D–MI), seeks to change the treatment of the "20" share so that it is taxed at ordinary income rates as well. This would have the effect of raising taxes more than 230 percent on the capital gains of fund managers. Simply stated, the concept embodied in H.R. 2834 is a bad idea motivated by the quest for more revenue, not tax fairness.

It is NTU's belief that the "20" portion should continue to be taxed at capital gains rates. Historically speaking, this portion of a fund manager's compensation has long been treated as a capital gain (and NOT ordinary income) because it represents the return on, or loss from, an investment. It is subject to the same risk factors as any other and receives capital gains tax treatment. It is only now that the capital gains tax rate has been lowered to 15 percent that attacks have been leveled at the "fairness" of this system. This suggests that the true complaints rest with the lower tax rate, not the supposedly improper treatment of the compensation.

Indeed, it is notable that other "fairness" aspects of capital gains tax policy have so far not merited Congress's attention, even though their implications are wide-ranging for all investors. For one, current law does not allow a taxpayer to adjust the value of an asset for inflation when declaring a capital gain. Moreover, even though the government subjects the full computed value of a capital gain to taxation, only $3,000 of a capital loss on a jointly filed return is deductible for income tax purposes in a given year. Because these limits aren't even inflation-adjusted, any "carryover" loss amounts for future years are being taken against a deduction that's losing value.

Congress established the lower capital gains and dividend tax rates because it wanted to relieve the double-taxation and market distortions that high rates impose. When individuals invest their dollars, they do so after having already paid income taxes on them. The 15 percent rate was intended to alleviate this double-taxation and encourage the kind of bullish financial outlook for which Americans are renowned. Raising the capital gains tax rate on a small but convenient segment of the economy will only establish a foothold for higher capital gains taxes on everybody in the future.

Higher capital gains taxes will discourage much-needed investment in many segments of our society. Thousands of colleges, pension funds, and charities invest their dollars in private equity plans so as to leverage scarce resources. Raising taxes would harm them immensely. Public employees, in particular, are heavily invested in the kind of plans that would be hurt by such a tax hike. It is difficult to believe that Congressional supporters of new tax treatment for carried interest intend to load an additional levy onto the pensions of teachers, police officers, and other public service workers. Such a policy would be all the more ironic, in light of the American Federation of State, County, and Municipal Employees' (AFSCME) official position that the 2003 capital gains tax cut "mostly benefits wealthy stockholders." If Congress travels further down the road toward taxing carried interest, AFSCME's members will learn a hard lesson about how harmful their union's stance is.

In addition, higher capital gains taxes would be a significant step in undermining the advancements in savings and growth that have taken place in the last few

years. Since 2001, an additional 12 million people have joined the investor class. Since 2003, household net worth has increased by an astounding $12 billion.

Such trends were evident several years before George W. Bush took office. In 1997, Congress enacted and President Clinton signed the Taxpayer Relief Act. This law actually led to a much steeper decline in capital gains rates than the Jobs, Growth and Tax Relief Reconciliation Act of 2003. The long-term maximum capital gains tax rate was reduced from 28 percent to 18 percent in most instances, while an even lower 8 percent rate was put into place for certain taxpayers. Although President Clinton expressed some "concerns" with the Taxpayer Relief Act, he predicted that the bill would "encourage economic growth." He was right. According to a detailed analysis by Standard & Poor's DRI, the new law helped to trigger a bull market for stocks that led to the rise of the "investor class."

Finally, it bears mentioning that even with higher capital gains taxes, revenues may not increase substantially. A 2002 CBO study pointed out that because such taxes are paid on "realized rather than accrued gains, taxpayers have a great deal of control over when they pay their capital gains taxes." This makes the capital gains tax particularly subject to revenue fluctuations resulting from changes in the rate. In recent history, every capital gains tax cut has resulted in additional revenue and every capital gains tax hike has resulted in less revenue. Any revenue gained from such a tax hike would be far outweighed by the damage done to pensions, universities, and charities across the country.

Alternative Minimum Tax

Much of the talk of raising private equity taxes would not be happening if it weren't for the Alternative Minimum Tax disaster. Like a parallel universe in the twilight zone of IRS rules and regulations, the AMT forces taxpayers to calculate their taxable income and liability under a different set of allowable exemptions, deductions, and credits. Because Congress designed the system so poorly and did not index the AMT threshold for inflation, it ensnares an ever-greater number of taxpayers each year.

In 2006, 4 million unlucky taxpayers paid the AMT. If Congress doesn't act, there will be 23 million equally unlucky Americans in 2007. These figures do not include millions of additional taxpayers who expended significant time either in tax planning to avoid being trapped by the AMT, or on IRS worksheets to determine whether they should complete Form 6251.

Despite promises to "fix" this problem every year, neither the former Republican Congress nor the current Democratic Congress has enacted a truly lasting solution. As a 2004 National Taxpayers Union Foundation study noted, "Continued delay will merely result in further losses to the economy and further corrective costs. It will also lead to a political motivation to design a solution which is 'revenue neutral' and thus cause further damage to the fiscal stability of the nation." Since that time, Congress has done little more than "kick the can down the road" by enacting one-year AMT patches.

Unfortunately, the new pay-as-you-go budget rules (PAYGO) make fixing the AMT highly unpalatable because of future revenue losses. Despite the fact that it was never intended to reach down into the middle class, the AMT now brings in substantial amounts of revenue each year. Under PAYGO, those ill-gotten receipts must now be offset so as not to violate its strictures.

Yet, PAYGO itself violates the very principles of "fairness and equity" around which this hearing has been designed. Under current rules, any tax cuts or new direct (mandatory) spending programs relative to the official revenue and outlay growth baseline are required to be funded through tax increases or spending reductions elsewhere.

But not all baselines are created equal. The mandatory spending baseline is assumed to be perpetual for entitlements such as Social Security and Medicare, while the 2001 and 2003 tax cuts are on a baseline that terminates in 2011. This double standard allows massive expansions in programs like Medicare Part D to be added directly to the deficit, while tax reductions are allowed to vanish unless they are extended with offsets.

Federal revenues have zoomed 28 percent over the past six years, and 2006's inflation-adjusted total exceeded the amount brought in during President Clinton's last year in office. During that same period, when Republicans controlled both branches of elected government, expenditures rose by an astonishing 49 percent. Recently enacted PAYGO rules create an inexcusable bias toward boosting Federal outlays while denying relief to taxpayers—thereby guaranteeing that this disparity will worsen.

While NTU would argue that budget process reforms should favor shrinking government, in the interests of "fairness and equity" Congress should, at the very least,

force spending-hikers to play by the same rules as tax-cutters. Rigging the process to grow already imperiled entitlement programs is not the kind of "new direction" that Americans were expecting from the 110th Congress.

Conclusion

Congress ought to repeal the AMT outright. It is a confusing, economically destructive tax that has spiraled wildly out of control since its inception. It was created in 1969 to deal with 155 high-income individuals who paid no income taxes. Today, it is a monster that threatens to grow even larger if it isn't vanquished once and for all. As it so happens, the encroachment of the AMT also provides a cautionary tale to those who believe that a "small adjustment" in the tax treatment of carried interest will remain so.

The way to bring down that beast, however, is not to raise taxes elsewhere. Private equity fund managers, though a convenient political target, are an important cog in the massive machinery that is the American economy. Raising taxes on certain forms of compensation will be highly destructive to America's public employees, unions, college students, and charities that rely on private equity.

Furthermore, while raising taxes is certain to be economically harmful, it is far from certain to enhance receipts. History shows that capital gains taxes constitute a fluid revenue source that fluctuates a great deal in response to rate changes.

If lawmakers seek tax fairness, they ought to focus on a fundamental overhaul of the IRS code, not piecemeal reform that only adds to the problem. With such a commitment, tomorrow's taxpayers will be most grateful to today's Congress.

Statement of NGVAmerica

Introduction

NGVAmerica appreciates the opportunity to provide the following statement concerning tax policy and its impact on energy policy, security and the environment. NGVAmerica is a national organization of over 100 member companies dedicated to developing markets for NGVs and building an NGV infrastructure, including the installation of fueling stations, the manufacture of NGVs, production and use of renewable natural gas, the development of industry standards, and the provision of training.

The Ways and Means Committee has indicated an interest in reviewing current alternative minimum tax (AMT) provisions. The primary purpose is to review the impact of this tax on working families and how it might be revised or amended to create more equitable treatment for taxpayers. NGVAmerica would like to encourage the committee to also consider how the current AMT provision limits efforts to stimulate the use of new energy efficient, non-petroleum technologies. Our statement addresses how AMT as currently structured discourages individuals and businesses from accelerating the introduction of alternative fuel technologies and ultimately limits efforts to reduce petroleum reliance.

Impact of AMT Provisions on Incentives for Alternative Fuel Vehicles and Infrastructure

The Energy Policy Act (EPAct) of 2005 (Pub. L. No. 109–58) includes incentives to encourage the acquisition of dedicated alternative fueled vehicles (AFVs) and alternative fuel refueling stations, among other things. The vehicle and fueling infrastructure incentives are found in sections 1341 and 1342 of EPAct 2005. The AFV credit expires on 12/31/2010 and the alternative fuel infrastructure credit expires 12/31/2009. NGVAmerica previously has submitted comments to the committee recommending that the credits be extended since the short timeframe for this incentive sends the wrong message to businesses and consumers about the government's support for AFVs, and is inconsistent with petroleum replacement goals espoused by the Administration and Congress. Congress has recognized this shortcoming and has introduced several measures that would extend these incentives.

Simply extending these tax credits, however, will not address another major shortcoming, namely, the fact that, as currently crafted, these tax credits are subject to AMT. The recently passed energy bill (H.R. 3221) partially addresses this shortcoming but only with respect to vehicles acquired by individual consumers. There is no adjustment for businesses that buy these vehicles, and there is no change at all with respect to the fueling infrastructure credits. The EPAct 2005 tax credits have been largely successful in accelerating the introduction of hybrid electric vehicles like the Toyota Prius and Honda Civic. Modifying the vehicle credits so that they are not subject to AMT will make it possible for more people to take advantage

of these new technologies. We applaud Congress efforts to expand these incentives for consumers. However, the proposed adjustment of the AMT provision for consumers is unlikely to help advance the use of AFVs among business fleets.

As currently structured, the corporate AMT provisions significantly limit the benefit of the AFV and alternative fuel infrastructure incentives. The tax credits for vehicles and fueling infrastructure are general business credits that are subject to AMT limitations. This is a major stumbling block to encouraging business fleets to buy large numbers of AFVs. Based on our analysis, the majority of fleets that buy large numbers of new AFVs will only be able to take advantage of the tax credits for a limited number of vehicles (if these businesses are not currently paying any AMT) or not be able to take advantage of any tax credits (if they currently are paying an AMT). This means that most fleets cannot make a major commitment to AFVs (i.e. acquiring large number of AFVs) without shouldering the additional financial investment associated with these vehicles. Given that these vehicles can cost tens of thousands of dollars more than petroleum fueled vehicles, most businesses have been reluctant to make the necessary investments without government assistance.

The most efficient way to commercialize AFVs is to encourage the purchase of these vehicles by large centrally fueled fleets. Focusing on large, centrally fueled fleets also is more efficient in terms of servicing and maintaining these vehicles (which may require special training), and providing alternative fuel infrastructure. Unfortunately, the Tax Code favors a strategy that requires industry to sell one or two AFVs to thousands of individual fleets in order to take advantage of the AFV incentives. This limitation also is likely to be a stumbling block for selling medium and heavy-duty hybrid vehicles to businesses as such vehicles become commercially available.

The incentives are also similarly limited with respect to the sale of vehicles and fueling stations to tax-exempt entities. The tax credits for vehicles and refueling stations (EPAct §§ 1341–1342) include provisions allowing the tax credits to be taken by the seller of the vehicles or fueling stations instead of the purchasers if the purchaser is a tax exempt entity. This provision was intended to ensure the Federal, state and local governmental agencies benefit from the tax incentives. This was viewed as an important provision in the law because government entities (e.g., municipal fleets, port authorities, transit agencies, school districts) in many cases are taking the lead in introducing AFVs. Congress provided this provision with the expectation that the seller would pass back some or all of the incentive to the buyer in the form of a lower purchase price. The Tax Code as modified by EPAct 2005 allows the AFV and alternative fuel infrastructure credits to go to the seller in the case of an acquisition by a tax-exempt entity. However, dealerships also are subject to AMT provisions and are, in most cases, only able to benefit in a limited way, if at all, from the sale of AFVs. Based on our discussions with numerous dealerships, we believe that most are not able to benefit from these incentives due to their tax status and, therefore, will not be able to pass any savings back to their tax-exempt (i.e., primarily government) customers. This means that state and local government acquiring AFVs will not benefit from these incentives.

Conclusion

NGVAmerica urges the committee to amend the Tax Code so that the incentives for AFVs and alternative fuel infrastructure are exempt from all AMT limitations. The current AMT provisions limit the ability of large fleet customers to acquire AFVs and also limit the ability of governmental fleets to benefit from the incentives. Modifying the incentives so that they are not subject to the AMT provisions will encourage businesses to invest in these new technologies and reward them for promoting practices that reduce petroleum reliance. When Congress passed these incentives, it believed they would encourage investments in AFVs and refueling infrastructure. However, the limitations addressed in our statement indicate that these incentives are not being fully utilized and are not having the intended impact. We urge Congress to correct this situation.

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