

Carried Interest – Fact vs. Fiction

Fiction: Private equity managers are just like money managers who are taxed at ordinary income rates for portfolio management services.

Fact: Private equity managers do far more to add value to the businesses they own than money managers. Money managers don't hire senior executives in companies in which they invest, they don't develop strategic business plans, they don't sit on boards of directors, and they don't have to pay their investors minimum returns before they can take their own profits. PE owners do all these, plus unlike money managers who can exit investments at a moment's notice, PE owners have no such liquidity.

Fiction: Carried interest is identical to a stock option which is taxed at ordinary income.

Fact: A carried interest is not the equivalent of a stock option. Stock options are granted by an employer to an employee. Private equity partners are owners of their companies, not employees of its limited partner investors. Moreover, it should be noted that if an executive exercises stock options and holds the stock for more than a year, the profit is in fact taxed at capital gains rates.

Fiction: Private equity partners take no financial risks and thus should not get lower capital gains rates.

Fact: Apart from the fact that private equity firms and their partners invest hundreds of millions of dollars of their own capital in their funds, all of which is at risk, they also carry the real risk that after years of time and energy they devote to growing investments, assets will not be sold at a profit.

Fiction: The carried interest piece of private equity compensation is granted without the beneficiaries putting a corresponding amount of actual capital at risk. Capital gains rates should be reserved for those with money at risk.

Fact: Capital gains rates have never been reserved only for those with money at risk. In fact, typical partnerships involve those with capital and those with ideas pooling their resources to build a success. The tax system rewards those who invest labor and expertise to grow a business as well as those who invest capital. In fact, to do otherwise would enshrine into law a policy that puts a higher value on the financial contributions of those with wealth than the contributions of vision and hard work from those who lack wealth and resources.

Fiction: It makes sense for venture capital partnerships to receive capital gains on their carried interests because funding start-ups is more risky than acquiring older, more mature businesses.

Fact: Both VC and PE firms provide capital, own companies, and contribute time, energy, talent and other resources to grow businesses over time. Both PE and VC partners assume the risk that the businesses in which they invest will not succeed, resulting in no profits. Accordingly, when they do succeed, there is no intellectually sound basis for treating the profits each sector generates differently. Qualitatively, there is nothing more virtuous about investing in early stage companies

than there is in more mature businesses. In both cases, venture capital and private equity do the same thing in essentially the same way — they invest and own companies, create value, encourage innovation and drive long-term growth. Since its creation in 1913, the tax code has treated both equally, and there is no rational or logical basis for departing from that approach.

Fiction: Higher taxes will not negatively impact the impressive returns generated by private equity for its investors, including state and local public employee pension funds, university endowments, and foundations.

Fact: It is impossible to predict the impact of higher taxes on investor returns. We've said that repeatedly. But it is also misleading to suggest, as many do, that pension funds dismiss the possibility that higher taxes would lower returns. Russell Read, Chief Investment Officer, California Public Employees Retirement System (CalPERS) testified that "It's hard to say with confidence that there would be no change in our negotiations (with PE firms) . . . In fact, my personal expectation is that this (higher taxes) will be a factor. How large a factor it'll be is a really open question, very difficult to know."

Fiction: Carried interest needs to be taxed at ordinary rates to ensure that the tax code treats all taxpayers fairly.

Fact: Congress decided there should be lower tax rates for capital gains for a variety of reasons, all of which are applicable to private equity. As long as one believes that taxing long-term capital gains at a lower rate is sound tax policy, there is no "inequity" in the current taxation of capital gains attributable to carried interests. Indeed, if Congress denies such tax rates to private equity, it is singling out one group of investors for less favorable treatment than others who do precisely the same thing. If Congress no longer believes having a differential long-term capital gains rate is fair, it should remove it for everyone, not just private equity investors.