Q&A on the Carried Interest Debate

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Introduction

Recently business taxes have gotten more attention, after six years of almost constant change to the individual code. Just weeks after Treasury Secretary Henry Paulson pointed to the high U.S. corporate tax rate as an obstacle to American competitiveness, Congress is reviewing the taxation of private equity funds, especially the "carried interest" earned by some fund managers that is taxed as capital income.

This discussion is timely and, perhaps, inevitable because rapid changes in the business world and the global economy are unmasking the schizophrenic way in which businesses are taxed under the U.S. tax code. Despite the fact that for the first time in modern tax history the top individual tax rate and the top corporate tax rate are the same (35 percent), there are still large differences between how businesses are taxed under the individual tax code and under the traditional corporate code.

A recent Treasury Department report illustrates how incremental changes in personal and corporate tax law over the past 30 years have caused some sectors of the economy to pay low rates and others high rates. This uneven tax policy is distorting investment decisions, making the economy less efficient and the nation less competitive.

One of the guiding principles of sound tax policy is that taxes should be neutral and not affect business decision making. As lawmakers study the taxation of fund managers, they should be cautious about rushing into a one-off solution. A more thoughtful approach would be to join with Secretary Paulson to review all of the unevenness of the business tax system and look for ways to make the tax code more rational. If lawmakers fail to consider a more comprehensive approach, they will find themselves facing these tax firestorms with increased frequency.

This Q&A is designed to help the lay reader put the current debate over carried interest in the larger context of business taxation in the U.S. today.

Q: What is carried interest?

A: Congressional Budget Office (CBO) Director Orszag testified in July that the innovations in U.S. finance, many of them in private equity and hedge funds, have boosted the U.S. economy and even smoothed out business cycles. Great profits have been earned from brilliant new financial products, and one of those new flows of income is called carried interest.

Carried interest is not interest in the sense of an interest-bearing savings account. It is a share in a fund. The person claiming that interest is the general manager of a private equity firm or hedge fund, and the carried interest is calculated as a percentage of the profits generated by the fund he manages. When the fund has a capital gain, the manager's percentage is treated as a gain to him, taxed like an ordinary capital gain on the sale of real estate or stock. Critics say this particular income source does not fit the correct definition of capital gain and should be taxed as wages.

Q: Is carried interest a major flow of income in the economy?

A: Carried interest is a small source of income even in the in the realm of non-corporate businesses. Compared to the economy at large, it is trivial, and its prominent role in the current tax debate is unwarranted. The IRS could have ruled on its own authority that carried interest did not meet the definition of a capital gain, but it has stuck with its current interpretation for years.

Q: If carried interest and the other obscure types of private equity income are earned by so few people and are not really economically important in the grand scheme of U.S. economic activity, why are they so prominent now?

A: Partly they are a political football put in play by recent, large new business deals on Wall Street in which a few private equity firms earned sensational profits. But more importantly, they shined a spotlight on an obscure issue in tax policy that actually is important—the different ways in which corporate and non-corporate businesses are currently taxed and how that affects business decision making.

Q: What are non-corporate businesses, and why have they been growing rapidly at the expense of corporate businesses for 20 years?

A: If a firm organizes as a regular corporation, called a C-Corporation, the income it produces is taxed twice by the federal government. The firm must pay the federal corporate income tax, usually at the statutory rate of 35 percent,[1] and then when it distributes after-tax gains to its shareholders, those people must pay individual income taxes on their gains, usually at a 15-percent rate. According to the OECD, not only is our corporate rate one of the highest statutory rates among OECD countries, but our combined tax rate of 50 percent on capital income is also near the top.[2]

Other business forms such as sole proprietorships and partnerships are exempt from the corporate income tax, and all the company profits are "passed through" to its owners, who are then taxed at the ordinary individual rate. Hence the generic name "pass-through entities" for

these business forms. Although the top individual tax rate is 35 percent—the same as the top corporate rate—avoiding double taxation can be a great boon to entrepreneurs.

Pass-through businesses can also take advantage of the individual capital gains rate of 15 percent. Meanwhile, traditional C-Corps are saddled with a capital gains rate of 35 percent. This makes them less nimble than pass-through entities and less willing to sell unproductive assets.

In addition to sole proprietorships and partnerships, these pass-through entities include S-corporations, limited liability corporations, and publicly traded partnerships (PTPs). These firms must comply with some legal limitations that C-Corporations are not bound by, but they retain many advantages of the regular C-Corporation without the major disadvantage of paying the federal corporate income tax.

As individual income taxes were cut in 1997, 2001 and 2003, mostly to benefit wage earners and home owners, flows of non-corporate business income have also been taxed at the lower individual rates. Today the effective marginal tax rate on C-Corporations is 29.4 percent, and on non-corporate businesses it is 20 percent. Often these differently incorporated businesses compete against each other, and the federal government should not saddle one business form with a much higher effective tax rate.

The Congress needs to see the current debate over carried interest as a sign, but not as a sign that we need dramatically higher taxes on pass-through entities. On the contrary, those firms have provided some of the greatest financial innovations that our economy is benefiting from every day. Instead we need fundamental tax reform that integrates the corporate and individual income tax codes and eliminates the double taxation that afflicts C-Corporations. Certainly one part of that will be lowering the corporate income tax rate, currently one of the highest in the world.

The federal statutory corporate income tax rate in the U.S. has been 35 percent since 1993. When combined with state corporate tax rates, the 39.4 percent combined rate is the second highest among industrialized countries. Only Japan taxes its corporations' income more heavily.

More Q&A on Business Taxation Generally

Q: What are business taxes and who pays them?

A: As their name implies, business taxes include all the taxes levied on any business enterprise, whether it's a large corporation or a Mom-and-Pop shop. Federal and state corporate income taxes are the biggest and best-known type of business tax. Others include gross receipts taxes as well as property taxes, license fees and various other fees and taxes.

While business owners physically write the checks to the tax collectors, they do not actually bear the entire burden of these levies. Some of the burden is borne by consumers in the form of higher prices, and some is borne by employees who receive lower wages because of business taxes. Business owners themselves get hit when the tax payment reaches the bottom line in the form of lower profits. What's certain is that all business taxes eventually hit individuals.

Q: Who bears the largest share of the business tax burden: customers, employees or owners?

A: It's hard to say. The burden of general taxes on business almost never falls on only one group. The split depends on how strong customer demand is, how unique the employees' skills are, and how tolerant investors are of lower profits. In other words, the burden can shift back and forth among the three groups depending on the state of the economy. In general, the brunt of the tax will fall on those least able to alter their behavior in response to the tax.

Q: Give an example of a business parceling out its tax burden to all three parties.

A: Say, for example, that a state raises its gross receipts tax. (This type of tax is typically one percent of every dollar a business takes in, no matter what its organizational structure or whether the business is profitable.) A business owner could try to avoid reducing profit by raising prices and reducing wages (or hiring fewer people). If consumers are unwilling to pay higher prices, they could avoid the burden by purchasing products made in other states. The business owners could respond to their customers' mobility by actually moving some of the business to other states. Both of these groups, then, have options to avoid the brunt of the tax. The employees can look elsewhere for work, but that's a much more difficult process; they have fewer options. Under such conditions, then, workers would largely bear the burden of the tax. Again, taxes will tend to fall on those least able to alter their behavior in response to the tax.

Q: Do these taxes affect how firms organize when they're founded?

A: Yes, business taxes have, over time, changed the profile of American firm structure.

Ideally, for the efficiency of the economy and the prosperity of the nation, fear of high taxes would not be a major factor in this essential business decision of how to organize. Businesses with similar income should pay similar taxes, no matter what their legal form. In some cases, organizing as a sole proprietorship makes the most business sense, but in others a partnership or corporation provides the best organizational structure.

Unfortunately, tax sense, not business sense, sometimes drives this essential business decision. Business taxes—particularly corporate income taxes—can differ dramatically for firms of different types that earn their income from different sources.

Q: Are other important business decisions overly affected by business taxes?

A: Yes. Business tax policy also affects the economy by influencing how firms finance their operations. Under current law interest payments are deductible from federal and most state corporate income taxes while dividends are not (though they are often taxed at a preferential rate). Therefore, all else being equal, firms have an incentive to finance their operations using debt rather than by issuing stock.

Q: What does the rapid growth of pass-through business entities mean to the economy over the long run and tax policy in general?

A: This is a good question. The economy is clearly hurt by a lack of clarity in business taxation in America today. Over time, it is likely that investors will continue to avoid double taxation and high corporate tax rates by incorporating as pass-through entities. The market is signaling where tax policy should be directed: lower rates and no double taxation. The question is whether lawmakers are listening.

Q: What, then, should guide business tax policy?

A: If economists have learned anything over the last 50 years it is that the market is very good at allocating resources. When businesses are going to be taxed we should strive to implement tax policies that are as *economically neutral* as possible. That means firms pay similar taxes on similar incomes, which allows them to make their important decisions about organizational structure and financing not for tax reasons but for economic reasons.

Notes

1. For a list of corporate tax rates in OECD countries, see Table 1 in this *Tax Foundation Fiscal Fact*: http://www.taxfoundation.org/news/show/22501.html.

2. http://www.oecd.org/dataoecd/26/51/33717596.xls

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