Analysis of the Impact of Increasing Carried Interest Tax Rates on the U.S. Economy

PART II
EXECUTIVE SUMMARY

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U.S. Chamber of Commerce

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Members of Congress have recently proposed to more than double 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% to ordinary income tax rates of up to 35%. This increased tax on limited partnerships would represent a departure from longstanding tax principles. It would undermine incentives for innovation, entrepreneurship, capital formation, and productivity growth that lead to rising paychecks for American workers. It would drive down the values of American pension funds, companies, and real estate even as America’s preeminent position in the global economy is being challenged by China, India, and other fast-growing emerging market nations where government leaders are designing policies to attract American capital.

The partnership structure is not a loophole. It has served as the cornerstone of the American way of organizing business and investment ventures for more than 50 years. It is not a tax haven for a few wealthy individuals. In 2005, 16.2 million American investors were partners in 2.8 million partnerships, holding $13.7 trillion in assets to engage in business and investment ventures in every sector of the American economy.

Hundreds of academic researchers have examined the impact of private equity on U.S. companies. Their evidence is unequivocal: private equity has positive productivity and financial performance effects wherever it is invested. Companies backed by private equity have better governance. They are more profitable, more productive, and faster growing than both public companies and the economy as a whole, and they hire more workers.

Venture capital has an extraordinary record in creating new businesses, new technologies, new business models, and new jobs. Venture-backed companies accounted for $2.3 trillion in revenue, 17.6% of gross domestic product (GDP), and 10.4 million private sector jobs in 2006.¹ Venture-backed companies grow faster, are more profitable, and hire more people. They are better innovators and secure more patents than public

companies. From 1980 to 2001, all of the net growth in employment came from companies younger than five years old.²

Real estate partnerships have increased the availability and lowered the cost of capital to build homes, shopping centers, office buildings, and hospitals. In 2006, investors provided $4.3 trillion in capital to the U.S. real estate sector, mainly 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), real estate investment trusts ($315 billion), and public untraded funds ($37.4 billion).³

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, energy, manufacturing, health care, research and development (R&D), retail, and distribution. Its purpose is to align the incentives between limited and general partners, and to focus everyone’s efforts on the long-term success of the partnership’s investments by making the general partner’s share of the fund’s profits contingent upon the successful harvest of the portfolio. 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.

Increasing the tax rate on carried interest would lead to wholesale changes in the structure of partnership agreements that have evolved over the past 50 years. New structures, including loan-purchase arrangements, shifting general partner expenses to portfolio companies, more leveraged capital structures, or a return to the deal-by-deal founder structures used in the early days of private equity would be expensive and inefficient—and would increase risk. Incremental net tax collections would be small.

To the extent that the tax increase could not be avoided by restructuring, the costs of higher taxes would be borne by all members of the investment process, including general partners as lower after-tax income, limited partners and their beneficiaries as higher costs and lower after-tax returns, and owners and employees of portfolio companies as lower business valuations and slower growth.

Increasing carried interest taxes would disrupt longstanding business practices in U.S. capital markets and reduce the amount of long-term capital available to the U.S. economy, undermining America’s preeminent position in the world as the leader in invention, innovation, technology, and entrepreneurial activities. Raising tax rates would reduce productivity, employment, and growth.

Raising tax rates on the long-term capital gains of limited partnerships would drive capital offshore, reduce the productivity of American workers, and limit the ability of U.S. companies to compete in global markets. 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. Raising tax rates on long-term capital gains of U.S. partnerships would hang a “not welcome here” sign on our door.

Foreign governments have learned that ample supplies of capital, modern technology, and experienced management are the keys to creating the rising incomes and economic growth their people are demanding. They are becoming more capital-friendly every day, changing tax and regulatory policies to reduce risk and increase after-tax returns for foreign investors who bring capital to their countries. They are waiting for America to make a mistake that would drive our capital offshore and into their welcoming arms. Raising tax rates on long-term capital gains for America’s partnerships is just the mistake they have been waiting for.
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