

House of Representatives Committee on Oversight and Government Reform

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Testimony of Joseph Bankman
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Mr. Chairman, Ranking Member Davis and Members of the Committee, thank you for inviting me here today to testify on the tax treatment of hedge fund managers. The views expressed here are my own and do not necessarily reflect the views of Stanford University.

1. Overview of Hedge Fund Organization and the Taxation of “Carry”

Briefly stated, hedge funds are investment partnerships. The investors -- institutions and affluent individuals -- are limited partners. The fund managers are general partners. Virtually all institutional investors are organized and located in the United States. Similarly most individual investors and managers are United States citizens who live and work in the United States. The hedge fund partnership, however, is often organized offshore, in tax havens as the Cayman Islands.¹ In recent years, hedge funds have held over a trillion dollars of stock and other assets. Many individual hedge funds have over a billion dollars of assets under management.

Hedge fund managers are compensated in two ways. First, they receive a management fee. This is typically 2% of the fund’s assets. Second, they receive a profits percentage. This is typically set equal to 20% of the fund’s profits. The profits interest is sometimes referred to as a carried interest, or carry.²

¹ There are often one or more partnerships or other legal entities interposed between the offshore operating partnership and the investors. These entities are used to accomplish other tax, regulatory or business-related objectives but do not significantly affect my analysis. The organizational structure is described in greater detail in Joint Committee on Taxation, “Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II,” (JCX-53-07), September 4, 2007, available at www.house.gov/jct.

² A summary description of the hedge fund and private equity industry, together with a description of the tax treatment of manager compensation, can be found in Joint Committee on Taxation, “Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I,” (JCX-53-07), September 4, 2007, available at www.house.gov/jct.

The portion of compensation received as a management fee is taxed as ordinary income. The tax characterization of compensation attributable to a profits interest is more complex. That characterization is made at the fund level. If the fund's profits are from the sale of capital assets held for over a year, the income will "flow through" to the limited partner investors as long-term capital gain. The amounts paid to the general partners as carry will also be taxed as long-term capital gain.

The amount of compensation received pursuant to a profits interest obviously depends on the profitability of the fund. Over time, however, the vast majority of income realized by a fund manager at a successful fund will come from his or her profits interest, and that income will be substantial. As an average over time, carry in excess of \$10 million a year is common. Top hedge fund managers have earned carry well in excess of \$100 million a year. One study found hedge fund managers earn far more than CEOs of publicly traded companies, and that hedge fund management is the most highly compensated of any profession.³

Private equity managers, such as venture capitalists or buy-out specialists, operate under similar compensation arrangements.

Capital gain is taxed at a maximum federal income tax rate of 15%. In contrast, the maximum rate on ordinary income is 35%. To the extent fund managers benefit from the capital gain preference they pay tax at less than half the rate as other highly paid professionals. That portion of manager compensation is taxed at a lower rate than compensation received by many, if not most, working individuals. A single individual, for example, pays tax at a 25% rate on any income in excess of \$32,500 a year. That is ten percentage points, or 40% (10%/25%) higher than the rate paid by the fund manager.

Carry is not only subject to a lower income tax rate than other income, it is exempt from payroll taxes. As a result, carry is exempt from the 2.9% Medicare tax that must be paid on compensation received by other high-income individuals.

The amounts paid as management fees generate a deduction that flows through to the fund investors and can be deducted from ordinary income. Amounts paid as carry reduce the investment income that fund investors recognize. To the extent the fund profits are capital gains, carry paid to managers reduces the capital gain recognized by investors.

In theory, structuring compensation as carry rather than management fees or other salary costs the investors a deduction that can be used to reduce taxes on ordinary income. In practice, however, the loss of this deduction is not important. Many hedge fund investors are tax-exempt and the individual investors often cannot deduct their portion of management fees due to Section 67 of the Internal Revenue Code (which

³ Steven N. Kaplan and Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* (July 2007) CRSP Working Paper No. 615, available at SSRN: <http://ssrn.com/abstract=931280>.

allows deduction for this and other miscellaneous items only to the extent such items exceed 2% of adjusted gross income).

The tax-favored treatment of carry has been estimated to save fund managers \$31 billion over the next 10 years.⁴ That figure encompasses both hedge fund and private equity managers. There are no official statistics as to the breakdown between those two (somewhat overlapping) groups, but the widespread perception is that private equity managers have realized a disproportionate share of this tax benefit. The reason for this is that many hedge funds currently have trading strategies that make long-term capital gain and loss unlikely and many hedge funds have elected to mark to market, precluding long-term capital gain treatment of gains. However, hedge funds that have not elected to mark to market are eligible for this benefit and it is possible that trading strategies in the future may change, making this benefit more valuable to hedge funds.

The low rate of tax on carry would be relevant in assessing the overall tax and regulatory burden faced by the hedge fund and private equity industry, even if that low rate reflected good tax policy. In my opinion, it does not. It is neither fair nor efficient.

2. Fairness and Efficiency of Capital Gain Treatment of Carry.

Tax scholars and policymakers generally divide fairness into two related concepts – vertical and horizontal equity. Vertical equity refers to the proper distribution of the tax burden among high-income and low-income individuals. The current (and past) tax law is progressive: high-income individuals pay a higher rate of tax than low-income individuals. For married individuals filing jointly, the first \$16,005 dollars earned are taxed at a 10% rate; additional income is taxed at progressively higher rates until income hits \$357,000. At that point, all additional income is taxed at a 35% rate. Some scholars, policymakers and legislators support a “flat tax.” Under a flat tax, income above a certain threshold amount (of around \$20,000) is taxed at a flat rate. Income below that amount is not taxed. The 0% tax rate on income below the threshold amount makes the flat tax progressive, though less progressive than the current tax structure.

No one, to my knowledge, has ever seriously proposed a regressive tax, under which the rate drops as income rises. Yet, as described above, that is exactly the effect of taxing the carry at capital gain rates. The fund manager who performs services is taxed at a rate of 15% on his carry, while the factory worker might be taxed at a rate of 25% on

⁴ Committee on Taxation, “Estimated Revenue Effects Of H.R. 6275, The "Alternative Minimum Tax Relief Act Of 2008," Scheduled For Markup By The Committee On Ways And Means On June 18, 2008” (JCX-51-08), June 17, 2008 available at www.house.gov/jct. The tax benefits are a function of the amount of carry, which in turn is a function of the amount of profits. The recent economic crisis will undoubtedly reduce the tax benefits realized in 2008 and most likely, in 2009.

his overtime. A fund manager who in 2007 earned \$80 million paid tax at a lower average rate than a high school principal who earned \$80 thousand.

The favorable tax treatment of carry is sometimes defended on grounds of horizontal equity. Horizontal equity is concerned with treating like taxpayers in the same manner. Supporters of the present treatment compare the fund manager to the entrepreneur, who is taxed at capital gain rates on the sale of her business. One problem with this argument is that fund managers do not perform the same functions or face the same risks as entrepreneurs. An entrepreneur may work for years with little or not pay, betting her entire economic future on the success of her idea, invention or efforts. If she is successful, she will have started a company that will itself recognize ordinary income on its profits. In contrast, fund managers perform intermediation and advisory services. They receive generous management fees and benefit from the performance of a portfolio of companies, the success of each of which is dependent on the inspiration and efforts of the entrepreneur.

One measure of how closely connected carry is to the provision of services is that some amounts taxed as carry are actually management fees that fund managers have simply elected to convert into carry. It is also worth noting that in statements to investors and to the Securities and Exchange Commission, some publicly traded fund management firms have described their business as the active provision of services.

A more fundamental problem with this argument is that entrepreneurs with whom the fund managers wish to be compared comprise a minute slice of American workers and a small slice even of those who go into business-related careers. Only a handful of students at Stanford Law and Business Schools, for example, fall into the category of serial entrepreneurs, starting and selling one company after another. For fairness (and efficiency purposes) it seems more sensible to compare fund managers to the far greater portion of their cohort who are taxed on their professional income at ordinary income rates.

The above analysis suggests that if the tax break on carry is justified at all, it would have to be justified on efficiency, rather than fairness, grounds. But the tax break on carry is inefficient. It reduces the size of our economic pie by distorting individuals' career choice. Presently, our best and brightest young people can become doctors, nurses, educators or scientists. Those with an interest in business might become executives, farmers, stockbrokers, lawyers, consultants or investment bankers. Income from all of those occupations, and countless other occupations as well, is taxed at a maximum rate of 35% (and bears an additional payroll tax). Alternatively, they can become fund managers, and face a maximum tax rate of 15% on much of their income.

A basic and common-sense rule of tax policy is that we ought to have the same rate of tax apply across different occupations or investments. The relative profitability of different professions, or investments, ought to be dictated by the market, not the tax law. The subsidy given to fund managers distorts their career choices, and in so doing reduces economic welfare.

It is sometimes argued that the risk inherent in the profits interest justifies capital gains treatment. As noted above, the fundamental problem with this argument is that it is generally efficient to have the same rate of tax on all forms of investment or compensation. There is no particular reason why the tax law should encourage (or discourage) risky investments, or risky forms of compensation. In this connection, it is relevant to note (as a matter of fairness, as well as efficiency) that other forms of risky compensation are not tax-favored. The electrician who starts his own business is taking a risk, as is the lawyer who takes a case on a contingency-fee basis. Yet the income of the electrician and lawyer is taxed as ordinary income, and subject to a maximum rate of 35%.

Industry spokespersons have made a number of other efficiency-based arguments in support of the preferential treatment of carry. They have argued that the low tax rate is justified by the importance of the work fund managers perform, or as a way to reduce the tax rate on key industries, or as a way to reduce the tax rate on investment in general. In my written statement accompanying testimony before the Senate Finance Committee in 2007, I explain why I believe these arguments are incorrect.⁵ In the interests of space, I will not repeat that explanation here. However, I would be happy to discuss these or any other arguments in my testimony today.

3. Tax deferral enjoyed by hedge fund managers.

In addition to benefiting from the low rate of tax on carry, hedge fund managers benefit from deferral of managements fees or carry-like contractual arrangements. Hedge funds have traditionally allowed managers to defer payment of these amounts. The deferred payment earns interest or investment return that is credited to the manager. No current income is recognized on the deferred fees or interest and investment return attributable to the deferred fees. Instead, the manager recognizes income only when, at his or her election, he or she receives cash in the amount of the deferred fees and investment return.

Through the arrangement, the fund manager can therefore limit his income to the amount he or she needs to spend or invest outside the hedge fund. The remainder can be saved on a tax-deferred basis

The tax law provides that where employees defer income on compensation, the deduction for the employer is similarly deferred. This matching principle usually limits the advantage of this sort of deferred compensation arrangement. As noted above, investors in hedge fund generally cannot use the deduction for fees paid to managers. They are thus indifferent to whether that deduction is deferred. The matching principle therefore does not limit the advantage of deferral of hedge fund compensation.

⁵ Testimony of Joseph Bankman before Senate Finance Committee, July 31, 2007, available at <http://finance.senate.gov/sitepages/hearing073107.htm>.

The benefit of deferral to fund managers is widely thought to be about as great as the benefit of the capital gain rate of tax on carry. Consistent with this assumption, the Joint Committee estimated the cost to the fisc (and benefit to taxpayers) of this form of deferral for the years 2009-2018 at over \$24 billion.⁶

4. Recommendations.

The tax advantage of deferral of management fees was eliminated by new Internal Revenue Code Section 457, enacted as part of the Emergency Economic Stabilization Act of 2008. That provision is effective beginning in calendar year 2009. Thus, 2008 will be the last year in which fund managers will benefit from deferral. The Alternative Minimum Tax Relief Act of 2008 contained a provision that would have taxed carry at ordinary income rates. That Act passed the House of Representatives in June, 2008, but died in the Senate. Thus, carry remains tax-favored. I recommend that Congress eliminate the tax advantage given to carry by again passing a measure similar to that contained in the Alternative Minimum Tax Relief Act of 2008. I recommend, though, that such a measure be amended to address the concerns expressed in the New York State Bar Association Report on Proposed Carried Interest and Deferred Fee Legislation.⁷

⁶ Committee on Taxation, “Estimated Budget Effects Of H.R. 7060, The “Renewable Energy And Job Creation Tax Act Of 2008,” Scheduled For Consideration By The House Of Representatives On September 25, 2008” (JCX-76-08), September 25, 2008 available at www.house.gov/jct.

⁷ New York State Bar Association, Report on Proposed Carried Interest and Deferred Fee Legislation, September 28, 2008., available at http://www.nysba.org/AM/Template.cfm?Section=Tax_Section_Reports_2008&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=20706