BROADER ISSUES IN TAXING HEDGE FUND MANAGERS AND PRIVATE EQUITY PARTNERS

Once upon a time there was a fairly rich society. In it lived 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 joined by hanging on to their appreciated assets instead of selling them and recognizing the income for tax purposes. Still others belonged because the society's legislature gave them an individual tax break, presuming they had paid business taxes on the same income—whether or not they did. A few squeezed in by figuring out how to arbitrage or leverage up differentials in the tax system. Membership in this last group grew larger each year.

Outside this low-and-no-tax club was another that paid fairly high marginal tax rates on money it had saved. Members included students saving for college, many welfare recipients, savings account holders, and some fairly successful executives who couldn't get in or didn't want to join the more exclusive club.

Many people belonged to neither club.

By and by, a debate arose over whether some of those who leveraged and arbitraged both financial investments and tax avoidance opportunities deserved membership in the no-and-low-tax club. Minutes of the club meetings detailed spats over some very technical membership rules, but most of the debate boiled down to two points:

- Those fearing they would be booted out argued that they were as deserving as many other rich members of this club.
- Their opponents argued that the group in question was no more deserving than those already excluded.

Both were right.

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This little vignette comes from my oral testimony before the Committee on Ways and Means on the taxation of "carried interest" (for the written version, go to http://www.urban.org). I used it to put the broader issue of club membership rules into context, rather than simply focusing on the tax treatment of hedge fund managers and private equity partners who get "carried interest."

If we're going to have a club whose members pay fairly low individual tax rates, we need to determine who deserves membership on the basis of principles.

Progressivity in taxation is one such principle to consider. In practice, that means imposing fewer and lower taxes on the poor. Equity and efficiency are other sound principles that tax policymakers and theorists often espouse. These touchstones suggest, for instance, that we might want to keep minimal any additional layer of individual tax on enterprise owners who have already paid a business tax on their earnings.

With one exception that I'll get to next, few argue that letting hedge fund managers and private equity partners in the club furthers either progressivity or efficiency principles. The one legitimate argument for these club members' special status is simplification—continuing to treat all types of income the same among members of partnerships. Hardly convincing at all is the related argument that we shouldn't pick on this particular set of partners when plenty of others (say, individuals who manage their own portfolios) get the same low tax rates. One wouldn't maintain, for instance, that Floyd Landis deserves to keep his Tour de France title over other competitors simply because he is as worthy as some other sports figures.

Some lobbyists leave principles like these aside altogether. They act like the proverbial defense attorneys who argue that the client did not steal the object, that it was worthless in the first place, and, that, in any case, it had been returned. The real-life version of this joke is that their clients are risk-takers and entrepreneurs beside whose work and investment everyone else's seems mundane and risk-free.

Alas, there is no policy principle on a par with progressivity, equal justice under the law for those in equal circumstances, or efficiency—the classics—that justifies subsidizing risk or entrepreneurs. In fact, there is no pure dividing line for identifying who are risk-takers and entrepreneurs. Even if there were, should Evel Knievel–wannabes have their taxes allocated by the width of the canyons over which they hurdle on their Harleys?

In point of fact, the bank account investor—who is not tax favored—probably faces a higher risk of getting a lousy real return on saving over the long run than many favored investors.

Unlike fables, this story has a bottom line instead of a moral: giving some people lower-than-average tax rates forces others to pay higher tax rates to support any given level of government spending. If that's okay with you, make sure it fits the principles you apply fairly to all taxpayers.