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Beware of Taxation of Private Equity Partnerships

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Under current law, taxes as a proportion of the national economy will rise sharply in the future, from just over 18 percent of GDP today to a record-breaking 20.9 percent within 18 years and to almost 24 percent before a newborn today reaches early middle age. This scheduled rise threatens the growth of the U.S. economy and the well-being of future generations.

Taxes need to be cut, not raised, and any purported tax reform ideally should reduce taxes; at the very least, taxes should not be further increased.

Proposals now before Congress to "reform" the tax treatment of private equity partnerships would substantially increase taxes. Some estimates put the size of the increase at as much as $100 billion over 10 years for some versions of the legislation. This tax hike would not only threaten the economy generally but would also jeopardize a particularly important and crucial part of the entrepreneurial economy: capital-intensive firms that take the risk of investing in and restructuring underperforming enterprises and putting them onto a sound footing. But bills by Senators Chuck Grassley (R–IA) and Max Baucus (D–MT) in the Senate and Representative Sander Levin (D–MI) in the House, and others in the works, would change the tax treatment of these partnerships. One bill would subject publicly traded private equity partnerships to multiple taxation. Another seeks to tax "carried interest" associated with these firms at high income tax levels rather than at the capital gains rate.

The bills are bad tax policy as well as mere stalking horses for an attempt to raise taxes by undermining the proper, lower tax rate for capital gains. Moreover, to the extent that a theoretical case can be made for taxing elements of carried interest as "labor income" that should be taxed as regular income, three important points must be considered.

First, income taxes should be limited to money associated with day-to-day management services separate from money associated with the risk-taking function of a partnership (or any other business, for that matter).

Second, sound tax policy requires that the costs associated with the management services should be made tax deductible to the partners for tax purposes. The current legislation does not address this side of the tax ledger—only the side that would raise revenue. In fact, if the appropriate deductions were included in any legislation, the result would likely be a slight decline in total tax revenues, not the hike foreseen by proponents of this "reform."

Third, under good tax policy, income is taxed only once, not multiple times. It is fortunate that today the tax code does not add corporate income tax to the other taxes paid by some publicly

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traded partnerships. But the Baucus–Grassley legislation would apply this additional level of taxation to many such partnerships. Rather than further entrench bad tax policy, Congress should be moving toward a sounder tax system by widening the current, limited exemption from multiple taxation.

Despite the talk of reform and loophole closing, the aim of these bills is clear: It is not to improve the tax code but to raise taxes even faster than under current law.

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