Carried Interest Tax to Carry Water for Reform?

Much of the difficulty Republicans are experiencing in passing tax reform is self-inflicted. They've fallen into a trap of the left by trying to ensure that the much-needed reforms to our outdated and punitive tax code are "revenue-neutral" — meaning the government continues to take just as much out of the economy in taxes going forward.

It's all well and good to avoid increasing the debt, but it's irresponsible to not even try accomplishing this with spending cuts. Deficit neutrality doesn't prohibit all increases in revenue through reform, but it emphasizes the need to address Washington's spending addiction through cuts — the only realistic way to address our long-term debt problem.

But that's apparently too much to ask of Republicans who have boxed themselves in to choosing bad ideas to help "pay for" desired reforms, such as tax cuts and code simplification, rather than debate which government agencies or wasteful programs we could do without. That approach, unfortunately, inevitably opens the door to changes that increase the tax bias against savings and investment — an issue already too prevalent in our tax code.

Hiking taxes on carried interest capital gains is one such proposal. Though there is a lot of inflammatory political rhetoric directed at the tax treatment of carried interest, there's a limited understanding of what it means.

For the many different business ventures organized as partnerships — which often include private equity, venture capital and hedge funds, as well as nonfinancial industries such as real estate — a carried interest is simply the share of a capital gain that is allocated to the general partner. The general partner manages the fund or business, while the limited partners provide investment capital.

Not only do many partnerships pay a management fee to the general partner but also some award a share of the venture's profits above a certain minimum rate (the carried interest) as an incentive to maximize the fund's return. Whereas the management fee is taxed as ordinary income, the carried interest is appropriately taxed as a capital gain. Assuming the partnership's income qualifies as a long-term gain, that means it's taxed at the lower long-term capital gains rate.

Democrats have long sought to tax carried interest not as a capital gain — despite the fact that it clearly is such — but as ordinary income. In fact, they desire to do that with all capital gains. To laymen's ears, that may sound fair, but it's neither fair nor economically sound.

A recent research paper from the American Action Forum found that raising the tax on carried interest "would likely inflict large damage on the commercial real estate sector, diminish its entrepreneurial talent pool, and lead to lower construction and wages in the real estate sector." Penalizing such things as venture capital and private equity funds, which are crucial for launching new businesses and expanding existing ones, would also weaken the economy.

Capital gains are a return for taking risks. Those who forgo consumption today to invest and grow the economy make us all wealthier tomorrow, plus the potential size of their initial investment has already been reduced by the presence of income taxes. In addition, investors — which often include not just wealthy individuals but also pensions and endowments — must risk losing their assets, which justifies treatment that differs from the treatment of ordinary wage income.

Unfortunately, the government imposes multiple layers of taxation on savings and investment, including not only capital gains taxes but also death taxes and taxes on dividends and corporate income. So really, we should be lowering taxes on capital gains, not raising them.

A group of Republicans led by Rep. Richard Hudson recently sent a letter to House Ways and Means Committee Chairman Kevin Brady, who is leading the tax reform effort, urging him not to raise taxes on carried interest capital gains. But it's hard to know how influential Hudson and company will be, because as a presidential candidate, Donald Trump attacked both the tax treatment of carried interest and his Democratic opponent, Hillary Clinton, for her failure to do anything about it while in the Senate.

Deciding that the tax treatment of a capital gain should depend on which partner it goes to is anything but fair. Such politically motivated and arbitrary provisions are precisely what reform efforts should be focused on abolishing.

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