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Fortunes fade on tax break

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Wealthy investors have spent years successfully beating back Democratic attempts to rein in their profits and practices, even getting off relatively easy during the current debate over the Wall Street reform bill.

But those days are coming to an end.

Two factors — an inhospitable political climate and a seemingly insatiable need for new revenue — have Democrats on the verge of rolling back special tax treatment enjoyed by fund managers at hedge fund, private equity, venture capital and commercial real estate firms.

Democrats are using the tax increase to help pay for the $143 billion jobs bill they are scrambling to finish before next week's Memorial Day recess.

Right now, most fund managers' paychecks include their portion of the gain on investments — and that money is treated by the IRS as capital gains, not regular income.

That arcane distinction means big bucks for managers, because capital gains tax rates are so much lower than tax rates on ordinary income.

The Democrats are trying to change that and treat gain on investments as regular income. If passed, the change would raise about $19 billion over 10 years by increasing tax rates for many fund managers as much as 25 percent.

Fund managers argue that the tax increase would reduce investment in startup ventures and other risky enterprises that drive innovation. Democrats, on the other hand, say the change would level the playing field by preventing wealthy investors from avoiding the income taxes everybody else pays.

And senior Democratic aides in both the House and the Senate say that this time industry lobbyists are unlikely to beat back the tax increase.

"This is something that a lot of members have wanted to do for a long time, and it seems logical to do it. And when you need to pay for stuff, this looks like the moment," a senior Democratic aide said. "I don't think that anybody thinks that this is going out of the bill."

Even industry insiders acknowledge that they are unlikely to defeat it and have focused their efforts on reducing the tax as much as possible.

The House has passed the tax increase on so-called carried interest twice since 2007, only to watch it languish in the Senate. In December, the House passed a jobs bill that included a provision to tax 100 percent of carried interest at ordinary-income levels rather than the 15 percent capital gains rate.

But last week, Senate Finance Committee Chairman Max Baucus and House Ways and

Means Committee Chairman Sander Levin proposed a change that would give fund managers a little breathing room. Rather than tax all carried interest as income, the bill phases in a provision that would eventually tax 75 percent of it at the higher rate. The remaining 25 percent would still be taxed at the lower capital gains rate.

The industry has trained its fire on inverting that ratio to further reduce fund managers' income tax liability.
Mark Heesen, president of the National Venture Capital Association, called the proposed 75-25 split "unacceptable," especially considering that venture capital funds growth industries such as clean energy and bio- and information technologies.

"There is one group that continues to create jobs in this country. It's companies that are funded by venture capitalists," Heesen said. "It's hard to kind of hit the folks who are literally on the frontlines creating jobs when others are getting bailouts."

Heesen acknowledged that persuading lawmakers to exempt venture capitalists from the tax increase is a tough lift but maintained that reducing the tax burden is possible.

"There are an awful lot of people in the House and Senate more than willing to work for us to see long-term investment rewarded ... while raising some revenue," he said.

Indeed, Democratic Sens. Maria Cantwell of Washington, Robert Menendez of New Jersey and John Kerry of Massachusetts have drafted a proposal that would postpone the tax's effective date and reduce the amount of carried interest it would cover to 60 percent. The proposal would further reduce, to 50 percent, the carried interest taxed as income on assets held longer than eight years, benefiting venture capitalists and developers.
Progressives are warily eyeing Cantwell, Kerry, Menendez and a number of Democratic senators they fear could support industry carveouts, including Tom Carper of Delaware, Ron Wyden of Oregon, Bob Casey of Pennsylvania and Mark Warner of Virginia.

The private equity industry has joined forces with commercial real estate developers and venture capitalists to "sow enough doubt into these senators' minds to make the outcome uncertain," according to an official representing the industry.

The private equity funds are mostly staying in the background, letting real estate and venture capital groups front the effort, the official said. It's easier to sell a message that the tax increase will cost jobs or imperil the building of a new supermarket than it is to defend hedge fund managers and private equity firms that make money by moving money.

The Private Equity Council and Real Estate Roundtable did not respond to requests for comment. The Managed Funds Association, which represents hedge funds, would not comment.

The Service Employees International Union is lobbying the senators to oppose any carveouts. They've activated their members in each of the states and asked them to contact their senators.

"If they do not get this done by the time they go home for recess, I don't know how they look their constituents in the eye and say, 'We chose wealthy hedge fund managers over your family,'" SEIU spokeswoman Lori Lodes said. "There is absolutely no defense for such a vote."

Democrats and their allies are betting that by framing the issue as a choice between working families and wealthy investment managers who, they charge, are gaming the system, they can capitalize on voter anger and punch through a change that has eluded them for years.

“It’s something people are running around and scurrying and lobbying to fight,” a senior House Democratic aide said, “but I think it’s at a point now where it’s on a path to becoming law.”