

Statement for the Record
of the
American Federation of Labor and Congress of Industrial Organizations
815- 16th Street, N.W.
Washington, D.C. 20006

Hearing on Carried Interest Part III: Pension Issues
United States Senate Committee on Finance
September 6, 2007

The AFL-CIO appreciates the opportunity to present our views as to whether ending the preferential tax treatment enjoyed by a select group of investment managers may impact pension fund returns. As the representative of 10 million working Americans who rely on pension funds and 401(k) plans for their future retirements, the AFL-CIO is engaged in an ongoing effort to promote public policy and corporate governance practices that protect our members' retirement security. The AFL-CIO strongly supports the current efforts in Congress to restore some measure of equity to the tax code by requiring hedge fund and private equity real estate and hedge fund managers to pay their fair share in taxes. We believe that both the Levin-Rangel bill, H.R. 2834, and the Grassley-Baucus bill, S.1624, would provide badly needed correctives to a tax system that has become grossly unfair.

Union members participate in benefit plans with more than \$5 trillion in assets; union-sponsored pension plans hold approximately \$400 billion in assets. In our view, the tax legislation being considered in both the Senate and the House of Representatives poses no threat to pension funds' returns on investments in private equity, real estate, and hedge funds.

The Levin-Rangel bill requires investment managers to pay ordinary income tax rates on their wages like all other Americans, while the Grassley-Baucus bill requires private equity firms and hedge funds that go public to either provide investors with the protections they are entitled to under the Investment Company Act or pay corporate taxes on their earnings.

Those opposed to taxing carried interest as ordinary income have advanced a variety of arguments, including arguments against further complicating the tax code and arguments about international competitiveness and capital formation. The real estate industry has gone so far as to link tax breaks for the wealthy with urban renewal programs. Each of these arguments has proved to be ill-founded and self-serving.

As to the focus of this hearing, i.e. whether changing the tax code would have a deleterious effect on pension fund returns, the AFL-CIO strongly agrees with the assessment of Orin Kramer, Hedge-Fund Manager and Chairman of the New Jersey State

Investment Council: “The argument that this is about the interests of retired public employees is ludicrous.”¹

The Levin-Rangel bill would require managers of certain private partnerships to pay ordinary income-tax rates of as much as 35% on “carried interest” which currently is taxed at the 15% long-term capital-gains rate. Carried interest, like performance bonuses, stock options, and restricted stock grants is a form of compensation intended to create an alignment of interest between investment managers and their clients. Carried interest, however, is the only form of incentive compensation that receives long-term capital gains tax treatment without limitations.² Changing the law so as to tax carried interest as ordinary income would simply remove an illogical and unjustified tax subsidy enjoyed by some of the wealthiest Americans.

The argument that requiring investment managers to pay their fair share in taxes would lower returns to pension funds and other investors because managers would, consequently, charge higher fees is not credible. Investment managers are prohibited from raising fees for current investors, as the fees are contractually established between the investor and the manager when the investor agrees to invest in a fund.

As to future investment, the firms will continue to charge what the market will bear. Current fees are already substantially higher than those charged by a wide range of money management alternatives—including bank trusts, insurance company separate accounts, and mutual funds. It is hard to imagine that alternative investment managers could command higher fees than they charge now – at some point the costs would outweigh the opportunity to earn higher-than-average returns and pension funds would simply invest their money elsewhere. The likelihood that pension funds would agree to pay higher fees becomes even more remote as interest rates rise and the credit markets tighten because these market factors make it more difficult to generate high returns using investment strategies that rely on borrowing, as private equity, real estate, and hedge funds do.

Opponents have also argued that, if carried interest is taxed as ordinary income, alternative investment managers will have less incentive to work hard and maximize returns for their investors. This argument is an insult to the working Americans who do their best each day despite having to pay ordinary income tax rates. It is hard to imagine that individuals who have the opportunity to earn tens, if not hundreds, of millions of pre-tax dollars would forego that opportunity because they might have to pay ordinary income tax rates rather than a subsidized capital gains rate.

¹ See "Buyout Firms' Tax Rise Wouldn't Hurt Workers, Pension Funds Say," Bloomberg News, July 11, 2007. <http://www.bloomberg.com/apps/news?pid=20601103&sid=aqyXkfhsNZmY&refer=us>

² §83 of the Internal Revenue Code requires employees who receive property, including stock, in exchange for services to either pay ordinary income taxes on the value of the property at the time they receive it and recognize any appreciation thereafter as capital gains or wait until they liquidate the property and then recognize the full amount they receive as ordinary income. Under §422(d) of the Internal Revenue Code, employees who receive incentive stock options may recognize \$100,00 worth of these options as capital gains each year.

Furthermore, the Grassley-Baucus bill would have no impact on the taxes paid by pension funds on returns from investments in private equity, hedge funds or similar alternative investment strategies. It would affect only those pension funds that buy units of publicly-traded asset management firms because these firms would have to pay entity-level taxes before making distributions to their investors. This tax treatment is no different than that required of traditional public companies that are required to pay taxes on their profits before paying out dividends. It is also unlikely that pension funds would invest in publicly-traded partnerships because, as institutional investors, they may invest directly in the private equity, real estate and hedge funds managed by these firms. Direct investors are entitled to preferred returns, are owed fiduciary duties by the investment managers, and have greater access to their individual money managers.

In sum, the AFL-CIO sees no valid justification for the individuals who manage private equity, real estate, and hedge funds to receive tax subsidies that leave the burden of paying ordinary tax rates to working people. The status quo imposes a real cost on working Americans—effectively using the tax system to redistribute wealth from working people to the wealthiest Americans.