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Edited by Andrew Ross Sorkin

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A Professor's Word on the Buyout Battle

October 3, 2007, 7:13 am

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Private Equity, Blackstone I.P.O., Special Section Fall 2007



By ANDREW ROSS SORKIN

MORE than a year ago, Victor Fleischer, an untenured professor at the University of Illinois College of Law, finished a draft of a paper about the tax treatment of private equity.

At the time, he was just hoping to get the paper published. Taxes are an unglamorous topic, and, worse, Mr. Fleischer's paper was about the arcane intricacies of "carried interest," hardly a household term. The paper argues that private equity managers are using a tax loophole to pay capital gains rates of 15 percent on carried interest, instead of the ordinary income tax rate of 35 percent. Carried interest, which comes out of a private equity fund's profit, provides most of the compensation for fund managers.

The paper eventually landed with some Congressional staff members, who were looking for ways to pay for a rollback in the alternative minimum tax. Today, carried interest is front-page news. It is the subject of hearings on Capitol Hill and the focus of a proposed bill, whose backers include Representative Sander Levin, Democrat of Michigan, that could cost executives in the buyout industry more than \$4 billion.

Washington's scrutiny has coincided with the initial public offering of the Blackstone Group, the equity firm, which yielded big payouts for its co-founder, Stephen A. Schwarzman, and other executives. The Senate is considering a separate measure, known as the Blackstone bill, that would raise taxes on Blackstone and other buyout firms that become publicly traded.

In August, when Mr. Fleischer testified before the Senate Finance Committee on carried interest, DealBook asked him about the whirlwind his paper had caused. Below are portions of that discussion.

Q. When did you first learn how private equity was taxed?



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A. I worked on a few private equity and venture capital fund formations when I was practicing law. This was back in 1999 and 2000. The partnership tax rules have been in place for a long time, since 1954. What surprised me was the huge disparity between carried interest and corporate stock options. They both compensate highly paid executives, but carried interest gets much more favorable tax treatment.

Q. *Did the disparity in tax rates strike you as a problem at the time?*

A. Not in the way that you think. I didn't focus on the distributive justice consequences of the rules. My job then was to help my clients. I was more focused on the way that the tax rules might distort the contract between the fund manager and their investors. Venture capital and private equity are fascinating institutions. They create new companies and turn around old ones. I was mainly interested in describing how the existing tax rules might affect the fund managers' incentives at the margins.

Q. *How did lawmakers get hold of your paper?*

A. I'm not sure. I assume a staffer was doing research on the industry and found a draft of my paper somehow. I was surprised and pleased. Academics get razzed all the time about being out of touch and irrelevant. So it's great to be able to contribute to a real-world debate.

Q. *Did you expect your paper to cause such a fuss?*

A. Honestly, I never thought anyone in Washington would read it except maybe as a part of a reform panel or something. I was trying to make a contribution to the tax literature, not stir up a hornet's nest in D.C. The issue has turned out to be salient in ways that I never expected. It's become a sort of proxy fight over the Bush tax cuts and the broader issues of income inequality. Obviously that goes way beyond what I expected.

Q. *Some say private equity firms will go overseas if the tax structure is changed. Do you agree?*

A. It's certainly true that, on the margins, some activity will move overseas. But not as much as people seem to think. And remember that the United Kingdom is looking at its carried interest rules, too.

Q. *What about those who say your proposal will not raise enough tax revenue to make a difference?*

A. When did \$3 billion or \$4 billion a year become trivial? It's not going to fix the alternative minimum tax by itself, but it's something.

Q. *How did the private equity community react to your proposal?*

A. Early on, I was approached by a lobbyist for the private equity industry, who offered me a consulting arrangement. I declined. Other academics have accepted money. Personally, I don't think academic research should be funded by clients who have an economic stake in the outcome.

Q. *Did you have friends in private equity? Are they still friends?*

A. I have a few venture capitalist friends who feel they were unfairly caught up in this. They see funding technology start-ups as very different from what private equity does with established

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companies. But it's not like I was out to hike taxes on anyone because I don't like the industry. I just want a tax system with a broad tax base, which allows for lower overall rates.

Q. *Do you think Congress would have seized on this issue without your paper?*

A. Presumably Congress would have found its way to this issue sooner or later. You know, it's not like I discovered a new theory of quantum physics. Private equity firms and their lawyers have known about this for a long time. My paper just teed it up as an issue of social policy that Congress might consider.

Q. *What do you make of the private equity industry's lobbying group, the Private Equity Council?*

A. The Private Equity Council has done a great job using sound bites to shape the debate. It started out as a debate about the tax rates that wealthy fund managers pay. Now it's about whether tax reform would hurt pensioners, minorities, and destroy capitalism as we know it.

Q. *Magic Johnson, the former basketball star, recently said he opposed changing the tax code for private equity, arguing it would hurt minorities and women. Do you buy that?*

A. That's ridiculous.

Q. *What do you think the effects of your paper will be?*

A. I hope the outcome of my work is getting tenure at the University of Illinois. As for D.C., I hope that Representative Levin's bill, or something like it, gets passed. But I'm not sure that will happen in the short run, and if it does, it would presumably get vetoed.

In the short term, I do think the Blackstone bill has a good chance. It's not a long-term solution to carried interest, because it only affects the handful of publicly traded private equity firms. But the bill responds to Blackstone's gamesmanship. Blackstone thumbed its nose at Congress with an aggressive tax structure in the I.P.O., and Congress will probably respond.

Q. *Who has done more to increase taxes on private equity, you or Steve Schwarzman?*

A. Definitely Schwarzman. I just wrote a paper.

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7 comments so far...

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1. October 3rd, 2007
10:12 am
Another lawyer wearing a white hat ... is it possible that the legal fashion world is changing?
— Posted by dt harris

 2. October 3rd, 2007
1:06 pm
"I just want a tax system with a broad tax base, which allows for lower overall rates."
Amen, brother, Amen.
— Posted by Veal

 3. October 4th, 2007
12:34 am
The professors at the University of Illinois come through again. He is addressing a very salient point in US tax law and I hope it gets the critical review it deserves. As a University of Illinois trained CPA I can tell you that all of these deals would not

happen if they did not have “economic substance.” I think the tax considerations are secondary in most of these deals.

— Posted by RonNV

4. October 4th,
2007
10:55 am

This is another case of an academic being totally out of touch with reality. The carried interest itself is not capital gain. It is only capital gain if the partnership itself has capital gain. The partners of the partnership should be free to allocate that capital gain as they see fit to reward and motivate the general partner. The focus of his article is “private equity or hedge funds”. The reality is that partnerships of all kinds have used this structure for years as a way to reward sweat equity and as a means for people who do not have access to bank credit to finance their business vision. This is a bad idea that if passed will someday be undone. If people in Congress are concerned about low taxes paid on capital gain . they should increase the capital gains tax across the board. And if they dont think high income people pay enough in taxes then the ordinary income tax rate should be increased.

— Posted by Blackhill

5. October 7th,
2007
4:02 pm

Why not divide the carry into two parts and calculate the tax based upon GP capital contribution. For example, let the percentage of carry taxed at the lower rate reflect the percentage of GP capital. The rest of the carry would be taxed at the higher rate. This would incentivize the GPs to put more of their own skin into the game and perhaps make them more astute investors (there’s nothing like eating your own cooking).

It’s not a perfect solution, but maybe an effective compromise?

— Posted by jc

6. October 17th,
2007
11:35 am

Hi, thank you for an in formative article that cleared my thinking on some matters. you did a good job.

could you give a longer explanation of carried interest. I think that may be usefull to me.

thanks again for this public service.

All the best.

jimmy f

— Posted by jimmy f

7. October 17th,
2007
12:35 pm

” I just want a tax system with a broad tax base, which allows for lower overall rates “.

What is this ivory tower lawyer smoking? When will congress reduce overall spending; never.

— Posted by K Fowler

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