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Dave Camp's Capitulation on Carried Interest

That's Obama's idea of "tax reform."

By John Berlau – 3.6.14

Once again, according to a White House summary of his 2015 budget unveiled this week, President Obama will call for "closing loopholes" that he says help "Wall Street." Once again, upon closer examination, these "loophole closures" are actually tax hikes that will hit Main Street the hardest.

There is something different this year, but that "something" is bad news for taxpayers and entrepreneurs. The difference is that House Ways and Means Committee Chairman Dave Camp (R-Mich.) has unfortunately signed on to some of these destructive proposals in the "tax reform" bill he introduced last week.

In particular, both Obama and Camp's "carried interest" proposals would tax much of the capital gains of partnerships as ordinary income as well as subject them to hefty payroll taxes for Medicare and Social Security. Small business folks and innovative entrepreneurs who structure their firms as partnerships will be hindered by both the cost and complexity of Obama and Camp's provisions aimed at "Wall Street" fat cats.

In his *Wall Street Journal* op-ed that ran last week on the day he unveiled his much awaited "tax reform" bill, Camp proclaimed that tax code "should not hinder small businesses from growing into large businesses. And the individual income tax needs to be simpler, fairer and flatter for everyone."

Camp's bill does make some needed and long overdue changes to the tax code. He gets rid of the deduction for state and local taxes, which has for decades favored high-taxing "blue" states. It trims the mortgage-interest deduction, a regressive deduction that encourages McMansions and was a big factor in the housing bubble.

It also gets rid of Obamacare's "medicine cabinet tax," which severely restricts the purchase of over-the-counter drugs in tax-preferred health savings accounts and flexible spending accounts. As I have written in *TAS* before, this stealth tax has the perverse effect of tilting consumers toward prescription drugs that would be cheaper to the insured individual but cost the health care system much more.

Camp also deserves many kudos for holding the IRS's feet to the fire in investigating its scandalous behavior toward conservative groups. But the same media that has buried the facts about IRS abuses will lap up a story about Republicans joining Democrats to be tax collectors for the welfare state. And the carried interest tax hike, whether proposed by Camp or Obama, is in a category by itself as absolutely horrific.

In fact, according to a *WSJ* news article, Camp himself proclaimed in 2010 that such a tax hike would "discourage the entrepreneurial risk-taking that is crucial to economic growth and job creation." Unnamed Camp aides in the article would only explain the flip-flop by saying the "context is different."

In the *WSJ* op-ed Camp calls for "clean[ing] up provisions like 'carried interest' that allow certain private-equity firms to get the investment-income tax rate on what anyone else would call normal wage income." Camp, Obama, and other proponents of the "carried interest" tax hike want folks to believe that this will only hit big hedge funds and private equity.

In reality, such a tax increase would be a direct attack on the structure of partnerships that are used by innovative businesses — from small firms to venture capital and "angel investor" groups — that take risks and make an outsized contribution to economic growth and job creation.

And the tax, as put forward by Camp's bill and Obama's budgets, would actually have a much broader reach to virtually all partnerships. Even with the lower rates in Camp's bill, this would still triple the taxation of a good portion of earnings for small business and entrepreneurs.

There is no asset or income threshold in Camp's bill or past Obama budgets, so firms from venture capital houses to doctors' offices to family farms, all of which are often structured as partnerships, could be negatively affected. According to a 2011 study by the accounting firm Ernst & Young, "flow-through businesses" such as partnerships and limited liability companies "employ more than one-half of the private sector workforce in every state except for Delaware and Hawaii."

And a report by the accounting firm KPMG on the Democrats' "American Jobs and Closing Tax Loopholes Act of 2010," which passed the House that year and came three votes short of the 60 needed to clear the Senate, found that the bill "could apply to partnerships in virtually any kind of business and could fundamentally change how partnerships are taxed."

In a partnership — from hedge funds to venture capital to small business — the partners are taxed on a business's earnings at individual tax rates, instead of the business itself being taxed at corporate rates and then doubly taxed on any dividends it pays out. In many partnerships, some partners get bigger stakes in the company because of the services they perform, in addition to the capital they have contributed. This is called the "carried interest."

The individual with the "carried interest" is taxed at the rates of ordinary income for his or her everyday salary and for much of the business's activities. But these partners pay the individual capital gains rate when the other partners receive capital gains for sales of such assets as stock and real estate.

Camp's bill and Obama's budget would drastically change this, taxing these gains as ordinary income and subjecting them to payroll taxes. This would more than triple the rate of taxation in many cases, even with Camp's lowering of rates overall.

Even if there were to end up being an asset threshold for partnerships — something not currently mentioned in Camp's bill or the summary of Obama's budget — this tax hike should still be rejected because of its devastating effects on the job creators. Although their investment strategies differ, large venture capital partnerships are organizationally structured in the same manner as private equity and hedge funds.

According to the National Venture Capital Association, "By more than doubling the taxes paid by venture capitalists on carried interest, Congress would be upending the risk/reward balance and creating serious economic consequences for very little revenue."

And as for reducing complexity in the tax code, which Camp says is his main goal, does the following passage sound like simplification? "The recharacterization formula generally would treat the service partner's applicable share of the invested capital of the partnership as generating ordinary income by multiplying that share by a specified rate of return (the Federal long-term rate plus 10 percentage points), intended to approximate the compensation earned by the service partner for managing the capital of the partnership."

This language comes straight the "section-by-section summary" of the bill on the House Ways and Means Committee website. One guesses that even if partners in a small business weren't subject to this new tax, paying an accountant to figure this out still would put them in the poorhouse. Doesn't really seem like this makes taxes "simpler, fairer and flatter for everyone," Camp's stated goal in the *WSJ* op-ed.

Camp's bill also has in common with Obama's previous proposals a foolish tax on banks and other large financial firms such as insurance companies. Camp's motivation, according to his summary, is to stop bailouts of so-called too-big-to-fail financial institutions, something that the Dodd-Frank "financial reform" has of course failed to do.

That's a worthy goal, but such a tax would likely have the opposite effect. As Mark Calabria, director of financial regulation studies at the Cato Institute, points out, "turning the banks into a revenue stream for the federal government" makes bailouts even more likely.

Such taxes would also be passed on to consumers. For instance, policy holders at life and home/auto insurance companies subject to the tax — including companies that had nothing to do with the financial crisis — would likely be hit with higher premiums.

Real tax reform will be a tough battle. Abandoning the me-tooism aspects of Camp's reform, while championing its strengths, is the first step.

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