

## Congress Hunts For Tax Targets Among the Rich

Revenue Search Looks  
Beyond Private Equity;  
'The Tip of the Iceberg'?

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Wall Street in recent years has devised increasingly complex ways for sophisticated players to make more money and pay fewer taxes. Now, with last week's move to boost taxes on publicly traded private-equity firms, lawmakers conveyed their determination to tap this ever-widening revenue vein.

Buyout firms aren't the only targets: Congress is taking a broad look at the tax advantages enjoyed by big wealth generators -- from hedge funds to oil companies to arcane investment vehicles -- and the individuals who profit from them. The next step could come as soon as today, with a House tax-writer expected to introduce legislation that would raise taxes on hedge-fund and private-equity managers.

The Democrats who took charge of Capitol Hill in January are determined to boost funding for health care, social programs, middle-class tax relief and the rest of their agenda. But they have promised to offset new tax cuts or spending increases with new revenue -- and to craft what they consider a more equitable tax code.

The boom in hedge funds and private-equity firms -- and the explosion of personal wealth for their investors and managers -- has put them and other easy political targets in the line of fire. The intensive focus on the Blackstone Group public offering slated for today, and the big fees for its executives, ignited the debate and prompted the introduction last week of legislation that would boost taxes on publicly traded financial partnerships. News that buyout firm Kohlberg Kravis Roberts & Co. is also going public will likely add fuel to the fire.

Ideas explored by congressional tax aides include increasing tax rates on the profits garnered by private-equity and hedge-fund managers -- which could end up boosting their payroll taxes as well -- and reining in hedge funds' moves to protect foreign investors from having to report income in the U.S., and to help tax-exempt investors avoid taxes.

Some ideas are more concrete than others. The next one likely to face public debate would essentially treat more of hedge-fund and private-equity managers' income as regular salary rather than more lightly taxed capital gains, as is the case now. Michigan Democratic Rep. Sander Levin, a senior member of the House Ways and Means Committee, is expected to introduce such a bill soon.

It isn't clear whether any of these steps could become law even if they cleared Congress, since President Bush remains staunchly opposed to tax increases and might veto such bills.

But regulators, too, are casting a critical eye on the financial-services industry's tax practices. Last month, the Internal Revenue Service established a branch of six attorneys to examine new financial products across an array of industries. "We've noticed more and more products, and because of the increasing complexity and increasing quickness of the markets, we're falling farther and farther behind," said Lon Smith, the IRS's associate chief counsel for financial institutions and products.

Private-equity funds buy companies using large amounts of borrowed money, hoping to quickly resell the acquired firms at a profit. Hedge funds are loosely regulated investment funds for institutions and the rich. As the Washington threat emerges, Wall Street appears divided on a response.

Mutual funds, investment firms and other Blackstone rivals are quietly supporting the pending private-equity legislation, which would tax publicly traded financial-services partnerships as corporations at a 35% rate instead of their current tax-free state (only partners, rather than the entity, are now taxed). That is because they think it would level the playing field. While the Private Equity Council, the industry trade group, issued a statement yesterday opposing the bill, rival private-equity funds have been muted in their criticism because they think that if Congress approves the legislation focused on Blackstone, it could ease pressure on lawmakers to look at broader tax increases and new industry regulation.

On the other hand, firms that haven't gone public -- but are thinking of doing so -- would be put at a disadvantage by

the bill, which gives a five-year exemption on the new tax level only to firms that have already filed their registration papers.

With a new focus on Wall Street, congressional and regulatory attention could ultimately turn to the long list of ways that different branches of the financial-services industry -- and the products they sell -- are taxed in wildly disparate ways from one another, despite similarities in the services they offer. If Congress wanted to look at other ways to close loopholes in the system, tax experts say, possible targets range from the favorable treatment accorded insurance policies, to sophisticated types of debt-equity hybrids that can convey huge tax breaks, to a variety of tax-favored means to buy and sell stocks.

**The private-equity bill "is just the tip of the iceberg," said Dawn Levy, a lobbyist with Cassidy & Associates and a former tax aide to Senate Finance Committee Chairman Max Baucus (D., Mont.). Ms. Levy says the Senate may address targeted changes in narrower bills, rather than introducing one broad bill. "It could be death by a thousand cuts," she said.**

The swirl around private equity intensified in Washington yesterday, when California Democratic Rep. Henry Waxman, the chairman of the House Oversight and Government Reform Committee, asked the Securities and Exchange Commission to delay the Blackstone IPO until Congress could hold hearings ([See related article](#)<sup>6</sup>). An SEC spokesman suggested the commission isn't in a position to act on this, saying the effectiveness of a

registration statement may be refused only if it contains "material misstatements or omissions."

But the request symbolizes the growing willingness by lawmakers to openly attack Blackstone and others like it. Beyond the bill on private-equity firms that go public, the biggest worry for hedge-fund and private-equity managers who have no plans to sell shares is the prospect that lawmakers will propose raising the taxes that fund managers pay on the share of profits known as "carried interest," to regular income-tax rates as high as 35% from the 15% capital-gains rate they currently owe. That is what the Levin bill imminent in the House would do.

Lawmakers said they continue to debate the question that is central to this tax issue: Should carried interest continue to be treated as investment income, as the industry would prefer, or is it more appropriate to characterize it as ordinary income?

"If it's capital gains, it's going to be taxed the same way they think it ought to be taxed. And if they're working for it, and it's earned income, they're going to pay a higher rate of taxation," Sen. Charles Grassley of Iowa, the ranking Republican on the Senate tax panel, said in an interview yesterday. He said a decision to introduce legislation hasn't yet been made: "We're still studying that."

Other proposals may also emerge after a broad, months-long inquiry by Senate aides into the tactics hedge funds and private-equity firms use to reduce their tax bills. House and Senate aides have raised concerns about money being

moved offshore to avoid U.S. taxes. They have questioned a hedge-fund practice of setting up "blocker" entities that can be used to protect foreign investors from having to report U.S. income or to help tax-exempt investors avoid taxes they must pay on debt-financed investing. Aides also have looked at whether managers are allowed to defer too much of their taxes, sometimes for years, by parking their management fees or carried interest offshore.

In an issue related to carried interest, Senate aides have been concerned that private-equity and hedge-fund managers, by characterizing much of their income as capital gains, also are reducing their share of federal Medicare and Social Security taxes. Changing the taxation of carried interest likely would require managers to pay more payroll taxes as well as income taxes.

But the first battle will be over the private-equity tax bill introduced last week by Messrs. Grassley and Baucus. In the past few days, Blackstone has drawn some allies. The U.S. Chamber of Commerce has devoted its entire team of financial-services lobbyists to defeating the legislation. The conservative Club for Growth has launched a media blitz against the bill and is considering a television-advertising campaign. And the top Democrat and Republican on the Senate Banking Committee have moved to slow the legislation.

But much of the industry has quietly left Blackstone alone. Hedge funds, mutual funds and venture-capital firms "believe uniformly that this loophole should be closed because it gives tax-advantaged-status to their competitors," says Andrew

Parmentier, an analyst who follows the legislation for FBR Capital Markets Corp.

The newly formed Washington trade association for the private-equity industry did issue a statement opposing the legislation, but not until nearly a week after it was unveiled. The delay was interpreted in Washington as a sign of hesitancy and could reflect a split among its membership.

Industry lobbyists say the trade group was torn between Blackstone and rival funds that think the five-year moratorium would unfairly benefit Blackstone.

Instead of fighting the legislation focused on buyout firms that go public, the Private Equity Council has been focused on developing a lobbying campaign to head off proposals that would raise taxes on all private-equity firms. Industry lobbyists hope to switch the debate's focus from the low tax rates paid by wealthy fund managers to the benefits that pension funds reap from investing in equity accounts.

The industry believes that shifting attention to pension funds could garner the votes needed to bottle up the legislation on Capitol Hill. In a preview of that strategy, Private Equity Council President Douglas Lowenstein last month told a House panel that investments by Washington state's pension plan in private-equity vehicles resulted in an average gain of \$26,000 per retiree more than if the funds had been invested in the S&P 500.

The escalating debate over the publicly traded partnerships and carried interest

highlights the discrepancies in how similar companies and products are taxed.

"The tax law is riddled with inconsistencies in which you can make the same economic bet and get very different tax treatment," said David Schizer, a tax-law professor and dean of Columbia University's law school. "This is especially true with sophisticated investments."

One area that Congress has repeatedly explored -- and may yet revisit -- is the world of tax-preferred corporate financing. In recent years, companies have issued roughly \$85 billion of so-called contingent convertible bonds, according to Thomson Financial. These are complex variants of hybrid debt-equity instruments. Although they have legitimate money-raising purposes, these bonds enjoy potentially even greater tax benefits than typical debt.

Typical corporate bonds allow companies to deduct interest payments from their income for tax purposes. But contingent convertible debt sometimes permits companies to take a deduction greater than the amount of cash interest that ever actually gets paid.

Congress has considered modifying tax treatment of these bonds at least three times since 2004. The latest attempt was offered earlier this year in a Senate bill to help offset tax cuts to businesses hit by a higher federal minimum wage. But it wasn't included in the final version that passed last month. It is one of the issues the IRS's new financial-products branch is examining.

There also are other issues related to tax advantages for hedge funds. Take for example the credit-card business. A U.S. bank operating a credit-card business would pay income tax on any profits it made. So would a foreign-based bank, if it did that business in the U.S. But an offshore hedge fund could purchase a portfolio of credit-card receivables and potentially not owe any corporate-level tax on the profits.

"The difference between many of the transactions undertaken by insurance companies, derivative dealers, broker-dealers and hedge funds can be close to zero for financial purposes," said Adam Rosenzweig, a tax-law professor at Washington University School of Law. "For this reason, financial practitioners could well attempt to make different investments with similar cash flows appear to be tax-preferred investments."