Bloomberg Businessweek

Bloomberg
Wednesday May 26, 2010

Buyout Firm Managers Face Tax Increase in Jobs Bill (Update1)

May 20, 2010, 4:38 PM EDT

(Adds that vote now planned for next week, resistance from lawmakers, starting in first paragraph.)

By Brian Faler and Alison Fitzgerald

May 20 (Bloomberg) -- Top congressional Democrats reached an agreement to increase taxes on managers of buyout firms and other investment funds as part of a jobs bill they plan to put to a vote next week in the U.S. House, lawmakers said.

The tax, designed to help defray the cost of the legislation, was scaled back from earlier proposals after pressure from some Senate Democrats and real-estate firms. It would affect companies such as Blackstone Group LP and KKR & Co. Lawyers, oil companies and businesses that use offshore tax havens would also see their taxes increase.

The bill would spend that revenue to extend unemployment benefits, a package of business tax cuts and a program to help local governments reduce borrowing costs. It would give $24 billion to aid states with Medicaid bills and delay for three and a half years cuts in Medicare fees to thousands of doctors.

“By promoting jobs here in the U.S. and cracking down on loopholes that encourage companies to move overseas, we strengthen opportunities for American workers and businesses,” said House Ways and Means Committee Chairman Sander Levin, a Michigan Democrat. He outlined the proposal with Senate Finance Committee Chairman Max Baucus of Montana.

Vote Delayed

Democrats say they aim to send the legislation to President Barack Obama by May 31, Memorial Day, though that will prove a challenge. Many lawmakers have expressed alarm over the cost at a time of mounting concern over the federal budget deficit. Democrats will also have to pick up the support of at least one Republican in the Senate, where lawmakers are already trying to finish a financial-regulation overhaul and a $60 billion war- spending bill by the end of the month.

While House leaders initially planned to bring the measure for a vote tomorrow, Majority Leader Steny Hoyer later postponed it until next week, saying members would be given more time to review the bill.

Asked if Democrats have the votes in the Senate to pass the plan, Dick Durbin, the party’s chief vote counter, said, “You’re way ahead of us.” Speaker Nancy Pelosi of California told reporters, “I think we will have the votes.”

Senate Budget Committee Chairman Kent Conrad, a North Dakota Democrat, criticized the size of the bill, saying “when I look at a package of this size I think we have to be tough about narrowing it down.”

‘Unprecedented’ Spending

Neither the text of the bill nor an official cost estimate were available as lawmakers made last-minute adjustments. Previous drafts put the cost between $180 billion and $220 billion, lawmakers said. The leaders offered only a summary of the bill today.

Representative Dave Camp, the top Republican on the Ways and Means Committee, said the “unprecedented deficit spending” in last year’s economic-stimulus plan “didn’t create jobs and neither will this bill -- this is just more spending on the same failed policies.”

Lawmakers did settle on a plan to help pay for the bill by increasing taxes on managers of investment partnerships.

Those managers are typically paid 2 percent of fund assets as an annual management fee and 20 percent of the profit earned for investors above certain levels. While the management fee is taxed as income, the share of profit, known as carried interest, is taxed at the lower capital-gains rate, currently 15 percent and slated to rise to 20 percent in 2011.

Compromise

While the summary of the legislation didn’t say when the higher tax would go into effect, today’s compromise would mean that carried interest would be taxed at a 30 percent effective rate this year and 34.7 percent next year, said Steven Schneider, a tax lawyer at Goulston & Storrs in Washington. With self-employment taxes, the rate would be higher -- 32.2 percent in 2010 and 36.9 percent in 2011.

The summary said it would allow carried interest that reflects return on invested capital to continue to be taxed at capital gains rates.

“The bill would require investment fund managers to treat 75 percent of the remaining carried interest as ordinary income,” the summary said. The top ordinary income marginal tax rate is 35 percent and is scheduled to rise to 39.6 percent next year.

The House has approved tax increases on carried interest paid to private equity executives three times in recent years only to see the measures die in the Senate. The proposal has won broader support this year amid pressure to avoid adding to the deficit.

‘Punitive’ Tax Increase

Douglas Lowenstein, president of the Washington-based Private Equity Council, in a statement called the proposed tax increase “punitive” and said it “will hurt those companies that are most desperately in need of capital to sustain or create jobs and drive growth.”

Mark Heesen, president of the National Venture Capital Association, said in a statement the plan “will more than double the taxes that long-term investors pay when they build successful companies and create jobs” and that he hoped it would be revised.

Democrats also agreed to make it harder for lawyers, doctors and other professionals to sidestep Social Security and Medicare taxes by organizing what are known as S corporations. That change would generate $9.6 billion in revenue over the next decade.

The bill would extend the Build America Bonds program through 2012 while gradually reducing subsidies offered through the initiative to 30 percent from 35 percent.

The program was created as part of Obama’s economic- stimulus package to help drive down the cost of borrowing for public works. It allows state and local governments to market their securities to pension funds and foreign investors, expanding their reach beyond the traditional buyers looking for income exempt from state or federal taxes.

--With assistance from Ryan Donmoyer in Washington. Editors: Laurie Asseo, Mark McQuillan.

To contact the reporters on this story: Brian Faler in Washington at bfaler@bloomberg.net; Alison Fitzgerald in Washington at afitzgerald2@bloomberg.net

To contact the editor responsible for this story: Mark McQuillan at mmcquillan@bloomberg.net