Testimony of Jack S. Levin to the House Ways & Means Committee

September 6, 2007

Mr. Chairman and Committee members, my name is Jack Levin. I teach at Harvard Law School and University of Chicago Law School, am author of a 1,400 page treatise on structuring venture capital and private equity transactions, and am co-author of a 4,400 page treatise on mergers and acquisitions. In my law practice at Kirkland & Ellis LLP, I have long represented many private equity, venture capital, and hedge funds and their trade associations, although I appear today to express my own personal views on the appropriate taxation of carried interests.

In my brief testimony, and at more length in my written statement, I will try to answer 6 questions:

First question, why do we tax long-term capital gain -- that is, to use the Code's verbiage, gain from the sale of a capital asset held more than 1 year -- at a lower rate than ordinary income, such as wages or interest income?

Several reasons: By imposing a lower tax on long-term capital gain than on ordinary income, Congress encourages the investment of risk capital in American business. I agree with this approach because the more risk capital invested into American business, the more our companies expand, create jobs and exports, and spread American prosperity.

Another reason for the lower tax rate on long-term capital gain is the recognition that it frequently takes many years to realize gain from a capital investment, by which time inflation has reduced the sales proceeds' real value. Stated another way, much of the so-called long-term capital gain does not really represent true gain because inflation has reduced the proceeds' value.

Second question, when a partnership recognizes long-term capital gain, why is the portion flowing to a carried-interest holder taxed as long-term capital gain?

We have traditionally had two systems of business taxation in this country. The corporate taxation system is very complex with double taxation (once at the corporate level and a

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second time at the shareholder level when the corporation makes distributions), §312 E&P calculations, §302 redemption recharacterizations, §305 stock dividend rules, §306 tainted preferred stock, §368 reorganizations, and 6 mind-numbing interest deduction disallowance rules.

The second system, for partnerships and LLCs, uses a flow-through approach and is designed to be much simpler and more economically rational, with a single level of tax, imposed on the partners when income is recognized at the partnership entity level, by allocating the partnership's income among the partners based on each's economic right to receive such income, with the income allocated to each partner retaining its entity-level characterization as (e.g.) ordinary income or capital gain.

This simpler partnership flow-through tax approach -- designed to encourage groups of people to join forces by combining their capital, labor, and know-how to start, build, and expand businesses -- has contributed mightily to the vibrancy of America's entrepreneurial economy.

So if a partnership holds stocks or other capital assets for more than 1 year, its gain on ultimate sale of those assets constitutes long-term capital gain in the hands of all the partners, both the pure capital investor and the part-capital part-management carried interest partner.

This is appropriate for a venture capital, private equity, hedge, or real estate fund because the general partners serve as the fund's principals or owners, selecting the fund's investments, sitting on the boards of the fund's portfolio companies, and making the fund's buy and sell decisions (like any owner of an investment), and generally making a substantial capital investment in the fund. General partners are not merely agents of the partnership, who have no capital at risk, merely making recommendations and following the dictates of their investor clients.

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Third question, should carried interest partners be taxed at ordinary income rates on their share of the partnership's long-term capital gain because as joint venture managers they are really receiving sweat equity?

For many decades the Code has conferred the lower long-term capital gain rate on gain from the sale of a capital asset held more than 1 year and throughout these decades the Code has never contained an absence-of-sweat test.

For example, assume Warren Buffett retires from Berkshire Hathaway and invests some of his money in stocks and real estate -- working 8 hours at his desk every day, including Saturdays, to pick which stocks and real estate to buy, hold, and sell -- and assume we have a videotape of his activities showing that on many days he did indeed break a sweat while studying reports and placing buy and sell orders. Is (or should) his long-term capital gain on his stocks and real estate held more than 1 year be converted into ordinary income?

Or if an innovative entrepreneur like Bill Gates and his investor group start a computer company, is (or should) the entrepreneur's long-term capital gain on sale of the computer company's stock be converted into ordinary income because he had many sweaty armpit days?

My point is that the Code does not make, and never has made, the absence or presence of activity and ingenuity -- or even a bit of bodily dampness -- the test for long-term capital gain, nor should we now legislatively adopt a test requiring IRS agents to poke around in Warren Buffett's or Bill Gates' dirty laundry searching for perspirational evidence.

But if we tax carried interest capital gain differently than other capital gain, isn't that the next step? If venture capital, private equity, and hedge fund managers who invest substantial capital and contribute substantial intangible assets in the form of (e.g.) know-how, reputation, goodwill, contacts, and deal flow are to be tainted by sweat, shouldn't the same rule apply to Warren Buffett and Bill Gates in my examples?

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Fourth question, do Steve Schwartzman of Blackstone and his peers make so much money that they should be taxed more harshly?

Whenever this august body has enacted punitive tax legislation based on vignettes, rather than on careful macro-economic analysis, our great country has been ill served. Perhaps the best example is the famous 1969 Congressional hearings that discovered 21 unnamed American millionaires paid no federal income tax for 1967. The direct result of those hearings is the odious, illogical, and counterproductive alternative minimum tax (or AMT) which has been an albatross around all our necks ever since, and which threatens to affect 25 million taxpayers in 2007 and 56 million by 2017.

Let's not repeat our past tax-legislation-by-vignette approach. Just because some private equity investors, or some athletes, or some thespians, or some computer-company founders make substantial amounts of money doesn't mean it is in America's best interests to impose tax penalties on them without carefully examining the macro-economic ramifications.

Fifth question, will changing the long-standing definition of capital gain to impose ordinary income tax on carried interests in long-term capital gain be harmful for the American economy?

Over the past 20 years or so, it has not been the big publicly traded auto companies and airlines that have provided growth in jobs, exports, and prosperity. Rather it has been the venture capital, private equity, and hedge fund financed companies that have made our economy the most efficient, vibrant, and emulated in the world.

If the carried-interest bill passes, will the flow of venture capital and private equity money into American business be reduced by 10%? By 20%? By 30%? Will American job growth, exports, and business vibrancy be curtailed? I believe there is substantial risk the flow

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of entrepreneurial investments will indeed be reduced, with significant harm to our vibrant economy.

So beware the law of unintended consequences and be slow to start down an opaque road if you don't know where it leads.

The basic principle of our free enterprise capitalistic economy is that American employment, growth, and prosperity will be maximized by allowing the free market to operate.

It is the antithesis of the free market when Congress enacts tax laws targeting specific activities and designating winners and losers, for example, taxing carried interest in venture capital, private equity, real estate, and hedge funds more harshly than other types of carried interest and more harshly than other investment gains. When Congress enacts laws picking winners and losers, with the tax rates and rules differing by industry, the free market is inevitably distorted, with great risk of dire long-term consequences for American economic growth.

Sixth question, will a slowdown in venture capital/private equity investing hurt only fat cat venture capital/private equity professionals?

Among the largest investors in venture capital/private equity funds are pension plans and university endowments. Thus, a slow down in venture capital/private equity formation and investing harms not only new and growing American businesses that do not receive the funding necessary to start up, grow, and prosper, but also the millions of American workers whose pension plans are the single largest venture capital/private equity investors and also the millions of American students whose tuition is reduced by their university's endowment profits.

I would be happy to answer any questions.

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