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Increased Federal Tax on Sales of Partnerships Will Cost Washington Jobs and Income

Briefly

Federal proposals would change the federal tax treatment of the sales of certain partnership interests. Such proposals would reduce jobs, personal income and investment in Washington.

The economy of Washington state is highly innovative and entrepreneurial, and this proposal would hinder our growth.

Over the last several years, President Obama and some members of Congress have sought numerous federal tax policy changes. One proposal, which initially focused on the tax treatment of carried interest (i.e., the share of partnership profits earned by general partners), has expanded to include higher taxes on certain partnership sales. In this brief, we address the economic impact of the proposed higher tax on Washington state.

First a little background. Proponents of these proposals often refer to the current tax treatment of carried interest as a "loophole," but it is actually the result of longstanding tax policy that grants preferential treatment to capital gains. Currently the 15 percent capital gains tax rate applies to carried interest; the proposed changes would subject carried interest to the higher (up to 35 percent) ordinary income tax rate. Additionally, in order to stop avoidance of the proposed higher tax rate, some of the more recent proposals would also apply ordinary income tax rates to gains from sales of investment service partnership interests. These gains are termed enterprise value; for simplicity's sake, we'll refer to the latter proposal as the enterprise value tax (EVT).

This EVT is the focus of this brief—not the broader carried interest issue. We examine the economic impacts under four different scenarios, as well as discuss the public policy implications of the EVT.

At the low end of the range, the EVT would cost Washington 3,687 jobs and reduce personal income by $429 million. At the other end of the range, the EVT would reduce employment by 9,774 jobs and cut personal income by $1,138 million. It is no better from a policy perspective; as the CEO of NYSE Euronext has said about the EVT, in a letter to congressional leaders, "it would certainly discourage new investment in American partnerships, stifle the spirit of entrepreneurship and pose a genuine threat to our still recovering financial system." The economy of Washington state is highly innovative and entrepreneurial, and this proposal would hinder our growth.

Impacts of Changed Tax Treatment of Enterprise Value

At this time there is considerable uncertainty as to the federal tax code in 2013 and thereafter. It is also unclear what share of long-term capital gains from the sale of partnership interests would be recharacterized as ordinary income under the proposed EVT. To encompass this uncertainty, we have evaluated four scenarios, which vary along two dimensions: (1) whether the Bush tax cuts are allowed to sunset or are extended indefinitely and (2) whether the percentage of long-term capital gains on partnership interests subject to the EVT is 50 percent or 20 percent. The results of the four scenarios are shown in the table.

The first scenario assumes that the Bush tax cuts are allowed to expire at the end of 2012, so that the maximum tax rate on capital gains reverts to 20 percent and the maximum tax rate on ordinary income for individuals reverts to 39.6 percent. This scenario also assumes that 50 percent of long-term capital gains on partnership interests will fall under the EVT. (The 50 percent figure was used in the Beacon Hill Institute's analysis of the impact of an EVT on Massachusetts [Tuerck et al. 2011].) Under these assumptions, we estimate that, nationally, individual taxpayers would pay $7.3 billion in EVT in 2013. Washington residents would pay $132 million of the individual EVT. Simulation with the WRC-REMI model indicates that the EVT would reduce employment in

Table: Impacts of enterprise value tax

Washington state by 9,184 in 2013 in this scenario, reduce personal income in the state by $1,068 million and reduce investment in the state by $256 million.

Scenario 2, like scenario 1, assumes that the Bush tax cuts are allowed to expire. This scenario, however, assumes that only 20 percent of long-term capital gains on partnership interests will fall under the EVT.

Scenario 1: Long-Term Rate 20%; Short-Term Rate 39.6%; Share of Long-Term Gains Subject to EVT 50%

Additional Tax Paid Due to EVT for Tax Year 2013 (millions 2013$):					
All Individual Partners	$7,252				
Washington Resident Individual Partners	$132				
	2013	2014	2015	2016	2017
Washington Jobs Impact	-9,184	-12,410	-14,840	-16,667	-18,104
Washington Personal Income Impact (millions 2013$)	-1,068	-1,288	-1,489	-1,669	-1,832
Washington Investment Impact (millions 2013$)	-256	-425	-551	-650	-731

Scenario 2: Long-Term Rate 20%; Short-Term Rate 39.6%; Share of Long-Term Gains Subject to EVT 20%

Additional Tax Paid Due to EVT for Tax Year 2013 (millions 2013$):					
All Individual Partners	$2,901				
Washington Resident Individual Partners	$53				
	2013	2014	2015	2016	2017
Washington Jobs Impact	-3,687	-4,981	-5,954	-6,686	-7,259
Washington Personal Income Impact (millions 2013$)	-429	-517	-597	-670	-735
Washington Investment Impact (millions 2013$)	-103	-171	-222	-261	-293

Scenario 3: Long-Term Rate 15%; Short-Term Rate 35%; Share of Long-Term Gains Subject to EVT 50%

Additional Tax Paid Due to EVT for Tax Year 2013 (millions 2013$):					
All Individual Partners	$7,400				
Washington Resident Individual Partners	$134				
	2013	2014	2015	2016	2017
Washington Jobs Impact	-9,774	-13,209	-15,795	-17,741	-19,271
Washington Personal Income Impact (millions 2013$)	-1,138	-1,370	-1,584	-1,776	-1,950
Washington Investment Impact (millions 2013$)	-273	-452	-586	-692	-778

Scenario 4: Long-Term Rate 15%; Short-Term Rate 35%; Share of Long-Term Gains Subject to EVT 20%

Additional Tax Paid Due to EVT for Tax Year 2013 (millions 2013$):					
All Individual Partners	$2,960				
Washington Resident Individual Partners	$54				
	2013	2014	2015	2016	2017
Washington Jobs Impact	-3,925	-5,304	-6,339	-7,119	-7,731
Washington Personal Income Impact (millions 2013$)	-456	-551	-637	-713	-783
Washington Investment Impact (millions 2013$)	-110	-182	-235	-278	-312

Under these assumptions, we estimate that individual taxpayers would pay $2.9 billion in EVT in 2013. Washington residents would pay $53 million of the individual EVT. These amounts are 40 percent of the EVT amounts paid under scenario 1. The reductions in 2013 Washington employment (3,687), 2013 Washington personal income ($429 million) and 2013 Washington investment ($103 million) are almost exactly 40 percent of the losses under Scenario 1.

Scenario 3 assumes that the Bush tax cuts are extended through 2017 and that 50 percent of long-term capital gains on partnership interests fall under the EVT. In this case individual taxpayers pay $7.4 billion in EVT. Washington residents pay $134 million of the individual EVT. In 2013, the state would lose 9,774 jobs, $1,138 million in personal income and $273 million in investment due to the EVT.

Finally, Scenario 4 assumes that the Bush cuts are extended and that 20 percent of long-term gains on partnership interests fall under the EVT. In this case individual taxpayers pay $3.0 billion in EVT. Washington residents pay $54 million of the individual EVT. In 2013, the state would lose 3,925 jobs, $456 million in personal income and $110 million in investment due to the EVT. These are almost exactly 40 percent of the losses under Scenario 3.

Carried Interest Background

While the focus of this brief is the higher tax rate on enterprise value, it's important to understand the related issue of carried interest. The carried interest tax proposals are mainly directed at private equity and hedge funds, which are often organized as partnerships. The compensation of these partnerships' general partners (who manage operations) consists of a fixed management fee and a share of the profits. This share of profits is called "carried interest." Under current law, carried interest is taxed as capital gains (the management fee is taxed as ordinary income).

Peter Orszag, then director of the Congressional Budget Office (CBO), in 2007 testimony on the taxation of carried interest, said that the question

> is whether a general partner's carried interest should be treated as a quasi-investment in the partnership by the general partner, with the result that carried interest would be subject to the same tax rules as apply to the limited partners' partnership interests, or whether the general partner's carried interest is more properly viewed as some form of contractual undertaking by the limited partners (or the partnership) to compensate the general partner for management services (CBO 2007).

Additionally, the testimony makes the point that

> the issues of characterizing a flow of income as a return on capital or compensation for services provided are not unique to private equity or hedge fund partners and are not new developments. Many real estate development deals, for example, are structured as partnerships with essentially similar characteristics.

Enterprise Value

Newer versions of the carried interest tax proposals would take the imposition of the ordinary income tax rate a step farther. In order to stop partners from selling certain partnership interests as a way to avoid the higher tax rate on carried interest, the more recent proposals would also tax the gains from sales of those partnership interests at the higher ordinary income tax rate. Those gains are considered "enterprise value" and are currently taxed as capital gains. The U.S. Chamber of Commerce describes "enterprise value" as being "the goodwill or brand value as well as the value of plant and equipment and other physical assets" (Chamber 2010).

President Obama's September 2011 legislative proposal, the "American Jobs Act of 2011," includes provisions that would apply ordinary income tax rates to carried interest for investment management services and to dispositions of investment services partnership interests.

Even under current law, sales of partnership interests may be taxed at both capital gains and ordinary income tax rates. An Internal Revenue Service audit technique guide on dispositions of partnership interests (IRSc) states,

> A partner who sells or exchanges a partnership interest must recognize gain or loss. Because a partnership interest is considered a capital asset, such gain or loss is considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in [Internal Revenue Code] section 751 (relating generally to the presence of assets within the partnership that would generate ordinary income if sold).

(The president's proposal would apply section 751 to dispositions of investment services partnership interests.)

In the proposal, "investment services partnership interest" is defined as "any interest in an investment partnership acquired or held by any person in connection with the conduct of a trade or business." In this context, a "trade or business" means:

- Advising as to the advisability of investing in, purchasing, or selling any specified asset.
- Managing, acquiring, or disposing of any specified asset.
- Arranging financing with respect to acquiring specified assets.
- Any activity in support of any service described above.

An "investment partnership" is any partnership in which "substantially all of the assets of the partnership are specified assets" and "more than half of the contributed capital of the partnership is attributable to contributions of property by one or more persons in exchange for interests in the partnership which (in the hands of such persons) constitute property held for the production of income." A "specified asset" is securities, real estate held for rental or investment, interests in partnerships, commodities, cash or cash equivalents, or options or derivative contracts."

The proposals are also included in the president's proposed fiscal year (FY) 2013 budget:

> The Administration proposes to designate a carried interest in an investment partnership as an 'investment services partnership interest' (ISPI) and to tax a partner's share of income from an ISPI that is not attributable to invested capital as ordinary income, regardless of the character of the income at the partnership level. In addition, the partner would be required to pay self-employment taxes on such income, and the gain recognized on the sale of an ISPI that is not attributable to invested capital would generally be taxed as ordinary income, not as capital gain.

(That last clause is the changed tax treatment of enterprise value.) According to the Office of Management and Budget, these proposals together would increase federal revenues by $1.287 billion in FY 2013 and by $8.269 billion over the 2013–17 period.

Discussion

EVT proposals, as our results show, would significantly impact jobs, personal income and investment in Washington.

The details of the proposals and the likelihood of their implementation remain unclear. The president's FY 2013 budget proposal on EVT, as described by the U.S. Department of the Treasury, newly recognizes the need to treat partnerships consistently:

> In order to prevent income derived from labor services from avoiding taxation at ordinary income rates, this proposal assumes that the gain recognized on the sale of an ISPI would generally be taxed as ordinary income, not as capital gain. To ensure more consistent treatment with the sales of other types of businesses, the Administration remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the ISPI holder (Treasury 2012).

And since then, a potential compromise has been hinted under which the president would continue to press for the higher tax rate on carried interest but not the EVT (Alesci 2012).

Dropping the EVT proposal makes policy sense. In an October 20, 2011 letter to U.S. House and Senate leaders, Duncan Niederauer, CEO of NYSE Euronext, said,

> I am very concerned about a provision that was included in the President's American Jobs Act that would tax profits on the sale of an investment management partnership at ordinary income rates effectively making investment partnerships the only businesses in the U.S. that would be ineligible for long-term capital gains treatment when they are sold. The lower tax rate that has been in place for 50 years has encouraged long-term investment and provided small and mid-size business owners and entrepreneurs the opportunity to grow and build value in their companies. Altering the tax treatment of these partnerships could have far-reaching unintended consequences on entrepreneurism, innovation, and capital formation in the United States.

Few states boast a more vibrant innovation economy than Washington. The Milken Institute ranks Washington No. 6 in its *State Technology and Science Index 2010,* and

Washington gets particularly high marks in the "technology concentration and dynamism" component of the index. Washington ranks No. 2 in *The 2010 State New Economy Index*, published by the Information Technology & Innovation Foundation and the Kauffman Foundation. The index comprises 26 indicators on categories including knowledge jobs, globalization, economic dynamism, transformation to a digital economy and technological innovation capacity. Washington ranks in the top 10 on all but economic dynamism, where the state comes in No. 29. Last November, Joel Kotkin, a prominent analyst of urban affairs and demographics, reported that Seattle ranked No. 1 of the 51 largest metro areas in the U.S. for high-tech growth.

Changing the tax treatment of certain partnership interest sales would, as our results have shown, have a considerable impact on our state's economy and could also negatively shock what Gov. Gregoire has called Washington's "innovative spirit."

Details of the Analysis

Long-term gains on partnership interests.

We estimate that nationwide individual taxpayers directly and indirectly had long-term capital gains of $65.2 billion on the sale of partnership interests in 2007. The calculation of this estimate began with the $49.1 billion long-term gain on sales of partnership, s corporation, estate and trust interests in 2007 as reported by the IRS (Wilson and Luddell 2010, Table 1a). We estimate that 90 percent of this gain is from partnerships based on the relative values of assets held in partnerships and s corporations in 2007 (Wheeler and Shumofsky 2009; IRSa) and our belief that gains on the sale of estate and trust interests were de minimis. This gives direct gains of $44.2 billion. We adjust gains up by 6 percent to capture gains on partnership interests held indirectly through trusts and by 39 percent to capture gains on partnership interests held indirectly through other partnerships. These percentages were based on income allocations by type of partner in 2007 (Wheeler and Shumofsky 2009, Table 5).

To estimate partnership capital gains in year 2013, we assume that these gains represent the same share of gross domestic production (GDP) in that year that they did in 2007. To estimate GDP in 2013, we use the Bureau of Economic Analysis's estimate for 2011 and the Congressional Budget Office's estimates of the GDP growth rate for 2012 and 2013 (CBO 2012).

We estimate Washington residents' share of capital gains of the sale of partnership interests by individual taxpayers to be 1.82 percent, which is Washington residents' share of income from partnerships reported on individual federal income tax returns in 2009 (IRSb).

Simulations with the WRC-REMI model.

We use the WRC- REMI model to estimate the impact on Washington state of the EVT. The WRC-REMI model is a dynamic simulation model of the Washington economy that incorporates a number of significant behavioral responses to changes in prices and costs.

The model divides the state of Washington into two subregions: the Seattle Metropolitan Statistical Area (King, Pierce and Snohomish Counties) and the balance of the state. There are 66 private industrial sectors within each subregion, as well as four governmental sectors.

We model the imposition of EVT as increasing the average cost of capital for each of the 66 private industrial sectors in the Washington state economy. The increase in the cost of capital varies across sectors based upon the partnerships' share of each sector's revenue in Washington state, as reported to us by the Washington State Department of Revenue.

We impose the EVT beginning January 1, 2013 and simulate the effects through the year 2017.

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