Statement of

Andrew Moylan
Government Affairs Manager
National Taxpayers Union

Prepared for

The Committee on Ways and Means
United States House of Representatives

Regarding the Committee's Hearing on

"Fair and Equitable Tax Policy for America's Working Families"

Submitted September 20, 2007

Contact Information:
Pete Sepp
Vice President for Communications
National Taxpayers Union
108 N. Alfred St.
Alexandria, VA 22314
703-683-5700
pressguy@ntu.org

Introduction

Chairman Rangel and distinguished Members of the Committee, thank you for the opportunity to submit written comments on behalf of the American Taxpayer regarding the important issues of tax fairness and tax equity. My name is Andrew Moylan, and I am Government Affairs Manager for the National Taxpayers Union (NTU), a non-partisan citizen group founded in 1969 to work for lower taxes and smaller government at all levels. NTU is America's oldest and largest non-profit grassroots taxpayer organization, with 362,000 members nationwide.

I write to offer our comments on the issue of tax fairness in private equity and the Alternative Minimum Tax (AMT). Few citizen groups in Washington can match NTU's 38-year history of participation in the national debate over tax fairness and simplification. We have established a principled stance in favor of lower, simpler taxes on all individuals and businesses, not just those who are politically in fashion at a given moment. You can find further research into these topics on our website at www.ntu.org.

Any discussion of tax fairness ought to begin with some context, by examining IRS data. Tax returns filed in 2005 indicate that on the same dollar, the wealthiest 1 percent of Americans paid an effective income tax rate nearly eight times higher than those in the bottom 50 percent. This picture does not change significantly even when taxes often thought of as "regressive" are included in the analysis.

A December 2005 study by the Congressional Budget Office (CBO) provides some illuminating statistics to prove the point. It accounted for ALL federal taxes, including income, payroll, and social insurance taxes, and broke the burden down by income quintile. CBO found that Americans in the lowest income quintile (who made an average of $14,800) paid 4.8 percent of their income in ALL federal taxes. Meanwhile, the highest quintile (situated at an average of $184,500) paid 25.0 percent of their income in taxes. Additionally, the top 1 percent of all income earners (who bring in an average of more than $1,000,000) pay 31.4 percent off the top in taxes.

This is hardly the picture of a Tax Code that is insufficiently progressive. The richest among us pay the most in taxes, in both absolute and relative terms. Yet, in spite of that fact, some Members of Congress persist in poisoning the tax policy debate with false rhetoric about the Tax Code being tilted toward the wealthy.

Private Equity Taxation

In the rush to find "pay-fors" to fund other priorities, some in Congress are now eyeing so-called "carried interest" taxes on private equity managers to raise additional revenue. These managers are compensated using the "2-and-20" method, which means that they get a salary worth 2 percent of the fund's assets and receive 20 percent of any capital gains the fund earns (also known as carried interest). If the fund suffers a loss, its manager receives nothing from the "20" portion and is compensated solely by the 2 percent portion.

That 2 percent is taxed at normal income rates while, under current law, the "20" component is taxed at the capital gains rate of 15 percent. One proposal, H.R. 2834 introduced by Representative Levin (D-MI), seeks to change the treatment of the "20" share so that it is taxed at ordinary income rates as well. This would have the effect of raising taxes more than 230 percent on the capital gains of fund managers. Simply stated, the concept embodied in H.R. 2834 is a bad idea motivated by the quest for more revenue, not tax fairness.

It is NTU's belief that the "20" portion should continue to be taxed at capital gains rates. Historically speaking, this portion of a fund manager's compensation has long been treated as a capital gain (and NOT ordinary income) because it represents the return on, or loss from, an investment. It is subject to the same risk factors as any other and receives capital gains tax treatment. It is only now that the capital gains tax rate has been lowered to 15 percent that attacks have been leveled at the "fairness" of this system. This suggests that the true complaints rest with the lower tax rate, not the supposedly improper treatment of the compensation.

Indeed, it is notable that other "fairness" aspects of capital gains tax policy have so far not merited Congress's attention, even though their implications are wide-ranging for all investors. For one, current law does not allow a taxpayer to adjust the value of an asset for inflation when declaring a capital gain. Moreover, even though the government subjects the full computed value of a capital gain to taxation, only $3,000 of a capital loss on a jointly filed return is deductible for income tax purposes in a given year. Because these limits aren't even inflation-adjusted, any "carryover" loss amounts for future years are being taken against a deduction that's losing value.

Congress established the lower capital gains and dividend tax rates because it wanted to relieve the double-taxation and market distortions that high rates impose. When individuals invest their dollars, they do so after having already paid income taxes on them. The 15 percent rate was intended to alleviate this double-taxation and encourage the kind of bullish financial outlook for which Americans are renowned. Raising the capital gains tax rate on a small but convenient segment of the economy will only establish a foothold for higher capital gains taxes on everybody in the future.

Higher capital gains taxes will discourage much-needed investment in many segments of our society. Thousands of colleges, pension funds, and charities invest their dollars in private equity plans so as to leverage scarce resources. Raising taxes would harm them immensely. Public employees, in particular, are heavily invested in the kind of plans that would be hurt by such a tax hike. It is difficult to believe that Congressional supporters of new tax treatment for carried interest intend to load an additional levy onto the pensions of teachers, police officers, and other public service workers. Such a policy would be all the more ironic, in light of the American Federation of State, County, and Municipal Employees' (AFSCME) official position that the 2003 capital gains tax cut "mostly benefits wealthy stockholders." If Congress travels further down the road toward taxing carried interest, AFSCME's members will learn a hard lesson about how harmful their union's stance is.

In addition, higher capital gains taxes would be a significant step in undermining the advancements in savings and growth that have taken place in the last few years. Since 2001, an additional 12 million people have joined the investor class. Since 2003, household net worth has increased by an astounding $12 billion.

Such trends were evident several years before George W. Bush took office. In 1997, Congress enacted and President Clinton signed the Taxpayer Relief Act. This law actually led to a much steeper decline in capital gains rates than the Jobs, Growth and Tax Relief Reconciliation Act of 2003. The long-term maximum capital gains tax rate was reduced from 28 percent to 18 percent in most instances, while an even lower 8 percent rate was put into place for certain taxpayers. Although President Clinton expressed some "concerns" with the Taxpayer Relief Act, he predicted that the bill would "encourage economic growth." He was right. According to a detailed analysis by Standard & Poor's DRI, the new law helped to trigger a bull market for stocks that led to the rise of the "investor class."

Finally, it bears mentioning that even with higher capital gains taxes, revenues may not increase substantially. A 2002 CBO study pointed out that because such taxes are paid on "realized rather than accrued gains, taxpayers have a great deal of control over when they pay their capital gains taxes." This makes the capital gains tax particularly subject to revenue fluctuations resulting from changes in the rate. In recent history, every capital gains tax cut has resulted in additional revenue and every capital gains tax hike has resulted in less revenue. Any revenue gained from such a tax hike would be far outweighed by the damage done to pensions, universities, and charities across the country.

Alternative Minimum Tax

Much of the talk of raising private equity taxes would not be happening if it weren't for the Alternative Minimum Tax disaster. Like a parallel universe in the twilight zone of IRS rules and regulations, the AMT forces taxpayers to calculate their taxable income and liability under a different set of allowable exemptions, deductions, and credits. Because Congress designed the system so poorly and did not index the AMT threshold for inflation, it ensnares an ever-greater number of taxpayers each year.

In 2006, 4 million unlucky taxpayers paid the AMT. If Congress doesn't act, there will be 23 million equally unlucky Americans in 2007. These figures do not include millions of additional taxpayers who expended significant time either in tax planning to avoid being trapped by the AMT, or on IRS worksheets to determine whether they should complete Form 6251.

Despite promises to "fix" this problem every year, neither the former Republican Congress nor the current Democratic Congress has enacted a truly lasting solution. As a 2004 National Taxpayers Union Foundation study noted, "Continued delay will merely result in further losses to the economy and further corrective costs. It will also lead to a political motivation to design a solution which is 'revenue neutral' and thus cause further

damage to the fiscal stability of the nation." Since that time, Congress has done little more than "kick the can down the road" by enacting one-year AMT patches.

Unfortunately, the new pay-as-you-go budget rules (PAYGO) make fixing the AMT highly unpalatable because of future revenue losses. Despite the fact that it was never intended to reach down into the middle class, the AMT now brings in substantial amounts of revenue each year. Under PAYGO, those ill-gotten receipts must now be offset so as not to violate its strictures.

Yet, PAYGO itself violates the very principles of "fairness and equity" around which this hearing has been designed. Under current rules, any tax cuts or new direct (mandatory) spending programs relative to the official revenue and outlay growth baseline are required to be funded through tax increases or spending reductions elsewhere.

But not all baselines are created equal. The mandatory spending baseline is assumed to be perpetual for entitlements such as Social Security and Medicare, while the 2001 and 2003 tax cuts are on a baseline that terminates in 2011. This double standard allows massive expansions in programs like Medicare Part D to be added directly to the deficit, while tax reductions are allowed to vanish unless they are extended with offsets.

Federal revenues have zoomed 28 percent over the past six years, and 2006's inflation-adjusted total exceeded the amount brought in during President Clinton's last year in office. During that same period, when Republicans controlled both branches of elected government, expenditures rose by an astonishing 49 percent. Recently enacted PAYGO rules create an inexcusable bias toward boosting federal outlays while denying relief to taxpayers – thereby guaranteeing that this disparity will worsen.

While NTU would argue that budget process reforms should favor shrinking government, in the interests of "fairness and equity" Congress should, at the very least, force spending-hikers to play by the same rules as tax-cutters. Rigging the process to grow already imperiled entitlement programs is not the kind of "new direction" that Americans were expecting from the 110th Congress.

Conclusion

Congress ought to repeal the AMT outright. It is a confusing, economically destructive tax that has spiraled wildly out of control since its inception. It was created in 1969 to deal with 155 high-income individuals who paid no income taxes. Today, it is a monster that threatens to grow even larger if it isn't vanquished once and for all. As it so happens, the encroachment of the AMT also provides a cautionary tale to those who believe that a "small adjustment" in the tax treatment of carried interest will remain so.

The way to bring down that beast, however, is not to raise taxes elsewhere. Private equity fund managers, though a convenient political target, are an important cog in the massive machinery that is the American economy. Raising taxes on certain forms

of compensation will be highly destructive to America's public employees, unions, college students, and charities that rely on private equity.

Furthermore, while raising taxes is certain to be economically harmful, it is far from certain to enhance receipts. History shows that capital gains taxes constitute a fluid revenue source that fluctuates a great deal in response to rate changes.

If lawmakers seek tax fairness, they ought to focus on a fundamental overhaul of the IRS code, not piecemeal reform that only adds to the problem. With such a commitment, tomorrow's taxpayers will be most grateful to today's Congress.