The Private Equity Scam Vis-A-Vis Taxes

Boy, listen to those Wall Street boys *whine!*

Congress has introduced a bill to change the way publicly-traded private equity firms are taxed, and they're not liking it at all.

Frankly, they're not going far enough. *All hedge fund managers should be taxed the way they're proposing to tax the public ones!*

What am I talking about?

Here's what all the furor is about.

When you invest, assuming you keep your investments for at least 366 days your capital gains are taxed at a lower rate. For instance, if you buy a stock for $20 a share and one year and a day later sell it for $30/share, you have a $10 gain per share.

Instead of ordinary income tax, you pay a lower tax rate on that $10.

This is justifiable because *investment puts people to work*. That is, by investing you make possible the employment of others, who will also pay taxes. The economy grows. Therefore, this beneficial act (to the general economy) is reasonably entitled to a better tax rate than ordinary income is. In addition, *when you invest you take the risk of a capital LOSS - that is, you might buy that stock only to see it decline in price to $10!*

At least this is the argument.

Well, for private equity guys, the game's a bit different.

See, they get 20% of the gains when they make investments and it turns out well. *But they don't share any of the losses when the bet goes bad, because they're investing other people's money!*

In my view, there is nothing here for them to complain about and in fact they should *thank* Congress because they've been able to profit from what was a clearly-wrong classification of their tax rate for a very long time! *These firms should have ALWAYS had their management income from profit sharing taxed as ordinary income, because everyone* ***else*** *who earns on this basis pays that rate!*

If you work for a company and they pay you a *performance bonus* of 20% of the firm's profits (split among the sales people, for example), *you pay ordinary income tax on that bonus.* Why is that not a capital gain? *Because you are not exposed to a risk of loss if the firm does not meet its profit targets!*

This has been an incredible windfall for these guys for **years** - a windfall that "ordinary investors" cannot take advantage of, and not even the rich can (usually) manage to pull off! You have to be able to find *other people* who will let you invest *their money* in order to pull this trick and get away with it.

Sorry guys, you'll find no sympathy here. As a trader and investor who has to take *actual risk of loss of my own capital* to qualify for the long term capital gains rate, I don't see where you should be able to circumvent those rules through tricky business structures.

I say pass the law and tax those gains as ordinary income - because it is.

Posted by Karl Denninger at 00:49

You're getting some political reaction, but it's a piece by a "lurker reader" of the mighty Ticker:http://tinyurl.com/2e8ue2Gentle vitriol - but does it burn just as bad as the hard stuff?Thanks for the blogs. Anonymous on Aug 2 2007, 19:56