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Battle Over Carried Interest Tax To Heat Up In Coming Weeks

The federal government's push to raise taxes on carried interest - and hence, cut into the profits of venture capitalists - will likely intensify in the coming weeks when lawmakers search for ways to pay for the high cost of health-care reform.

At a venture industry conference Thursday, Mark Heesen, president of the National Venture Capital Association, said health care reform will be at the forefront of the Ways and Means Committee over the next two months.

"They made clear they will look under every rock out there to find any kind of potential revenue to offset health care reform," Heesen said at the International Business Forum's venture capital conference in San Francisco.

Venture capitalists successfully fended off a bill two years ago that would have treated carried interest as ordinary income, with its 35% tax rate, instead of the 15% capital-gains rate. The Senate struck it down.

But that was 2007 when the stock market was still soaring and the economy appeared to be pumping. This year, in the midst of economic turmoil, the legislative train thundering through Washington will be hard to stop.

In February, President Obama's 2010 budget plan brought the issue back on the table. Carried interest, or the share of profits that venture capitalists receive after cashing out of portfolio companies and returning money to their limited partners, will be taxed as ordinary income starting in 2011 if the President's proposal is approved by Congress.

Then in April, that bill from 2007 rose from the dead, introduced by Rep. Sander Levin, D-Mich., who was a part of the original legislation. Like President Obama's plan, the bill would affect all partners who receive carried interest, whether private equity, hedge funds, venture capital or real estate partnerships.

That, of course, doesn't sit well with the venture capital industry, which has been fighting to separate themselves from shorter-term asset classes that aren't focused on job creation.

One longtime venture investor who works at a firm that does both venture capital investments

and buyout deals, Bob Grady, a managing director at Carlyle Group, suggested the fight over carried interest may already be over.

“I think this battle is largely lost,” said Grady, who once served as the chairman of the NVCA. “There’s no sympathy for venture capital or private equity.”

NVCA’s Heesen, whose organization intends to fight for the industry until the bitter end, disagreed.

“Venture capital is perceived extremely differently in Washington,” Heesen said. “Interest is not interest. Mortgage interest and credit card interest are the same, but are they treated differently in Washington? Absolutely.”

Grady said it would be difficult to separate out venture capital from other private equity, especially if buyout shops or hedge funds make small amounts of venture investments to qualify as a venture firm.

Heesen however said it would be possible to distinguish, based on length of investment, size of investment and duration of investment. Heesen said he met with Representative Barney Frank, chair of the House Financial Services Committee, last Friday and said Frank understands the difference with venture capital.

“He made very clear to us that he does not see venture as being a regulated industry,” Heesen said. “That’s good news, but that’s only one member.”

Dixon Doll, general partner at DCM and outgoing chairman of the NVCA, called the issue “one of the battles of our lives.” On a related issue, Doll reiterated the NVCA’s proposal for a one-time incentive providing a 10% capital gains tax rate for IPO investors who held shares for two or three years.

“One of the things the NVCA is fixated on is to create a differentiation between our industry and other industries by being willing to compromise on the holding period to preserve capital gains,” he said.

Given the way regulation is increasing, such a change should possibly be considered by the industry, he said, while making a joking jab at Carlyle’s Grady.

“That’s the period we’re heading into. I don’t think that actually harms us as an industry,” Doll said. “Because if you look at the holding periods for most equity we purchase it’s considerably longer than the holding periods characterized by “our friends” - I use those words in quotes, no offense Bob - in private equity and hedge funds.”