Democrats back down on ending tax windfall for hedge-fund billionaires

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In a clear demonstration of their subservience to Wall Street, Senate Democrats have pulled back from proposals to end a huge tax loophole for the wealthiest financial speculators—the billionaires who operate hedge funds and private equity firms.

At a hearing Tuesday before the Senate Finance Committee, spokesmen for the big financial interests denounced proposals to tax the compensation of hedge fund operators as ordinary income—at a rate of 35 percent—instead of at the 15 percent rate applied to capital gains.

Gargantuan sums of money are at stake in this discussion. Hedge funds and private equity firms have mushroomed over the past decade into enterprises controlling as much as $2.5 trillion in capital. They pay their executives incomes of as much as $1 billion in a single year. Steven Schwarzman, CEO of Blackstone Capital, netted nearly $600 million in a single day when the firm went public in June, and his stake in the company is valued at over $4 billion.

While the financial arrangements of hedge funds are arcane, the tax loophole is elementary. Hedge fund managers receive two income streams, typically 2 percent of the fund's total value and 20 percent of the profits. The 2 percent is taxed as income, but the 20 percent of the profits, called "carried interest," is taxed at the rate of capital gains, although it is return on the investors' capital, not on the capital of the hedge fund managers. A bill introduced in the House would define carried interest as income, not capital gains, effectively raising the rate from 15 percent to 35 percent.

While Republican senators denounced the proposed tax increase on general principles, since they oppose any form of taxation of the wealthy, the Democratic senators had to tread more carefully, balancing their loyalty to the financial aristocracy with the need to strike a populist pose and present themselves in the guise of advocates of working people.

The lead was taken by two proven advocates of the moneyed interests, Charles Schumer of New York and Christopher Dodd of Connecticut, who distanced themselves from the proposal by House Democrats for a tax increase on all hedge fund and private equity operators, and even from the minimal measure introduced by Senate Finance Committee Chairman Max Baucus of Montana, which would raise taxes only on private equity firms like Blackstone that go public by selling shares on the stock exchange.

Schumer has made noises about increasing taxes on the wealthy, but in an interview with the *New York Times* published the day before the Senate committee hearing, he declared, "I am not a populist," and offered a series of evasions from a straightforward explanation of why hedge fund billionaires should pay a lower tax rate than the janitors and secretaries who work in their Manhattan offices.

According to the *Times* account, Schumer said that he had promised Wall Street executives "he would oppose a tax increase as long as it did not also apply to other industries, like energy and real estate. Both in and out of Congress, supporters of increasing taxes on hedge funds and private equity firms say Mr. Schumer's proposal is a 'poison pill' that would generate opposition to the measure from powerful groups—the energy and real estate industries—and derail its prospects for passage."

Dodd, chairman of the Senate Banking Committee, issued a statement declaring he was "concerned about the potential adverse effects that these proposals would have on capital formation, on job creation, and on institutional investors." This is just boilerplate to cover blatant favoritism towards the wealthy. Dodd is well aware that private equity firms are implicated in the destruction of tens of thousands of jobs through the takeover of companies which are then "stripped and flipped," in the gangster-like jargon of the industry.

Dodd's long shot campaign for the Democratic presidential nomination is financed largely by big financial interests, including the numerous insurance companies in his state and the many Wall Street multi-millionaires and billionaires who reside in posh Connecticut suburbs of New York City, like Greenwich.

Other Democratic senators voiced caution about demands to end the private equity loophole. John Kerry of Massachusetts warned, "You've got to think carefully" about the potential consequences of such a move, which could have "downstream impact." He cited the current turmoil in the stock market as another reason for going slowly, observing, "I think you've got to think carefully, particularly with this market."

Kerry even compared the activities of private equity funds to those of small businesses, claiming, "In a lot of these deals, they are required to put up their money." The Democrats' 2004 presidential candidate is married to the billionaire heiress Teresa Heinz.

Ron Wyden of Oregon suggested that instead of a one-off increase for private equity and hedge funds, there should be a broader effort to reform the tax system, ending loopholes for other sections of the super-rich. Like Schumer's diversion, Wyden's proposal is an attempt to alibi for his abject subservience to Wall Street interests. His sentiments were echoed by Finance Committee Democrat Ken Salazar of Colorado.

Another Senate Democrat, multimillionaire Maria Cantwell of Washington, herself a software executive before winning a Senate seat in 2000, found another issue to divert attention from the windfall for the private equity bosses. Closing the loophole might hurt the financial performance of pension funds for state employees of Washington and other states, she claimed, because pension fund managers have heavily invested in hedge funds and private equity.

The Senate Democrats' opposition to increased taxes on the super-rich is directly linked to the flow of funds from these wealthy interests into the Democratic Party's campaign coffers. In the first six months of 2007, the Democratic Senatorial Campaign Committee—headed by Schumer—raised nearly $2 million from executives and employees of private equity and hedge fund firms such as the Carlyle Group and the Blackstone Group, according to an analysis by the Center for Responsive Politics.

The Private Equity Council gave 69 percent of campaign contributions to Democrats in 2006, after splitting its donations 50-50 with the Republican Party as recently as 2000.

John G. Gaine, president of the Managed Funds Association, the trade group for hedge funds, hailed Schumer as a "guardian of America's capital market and, more parochially, New York's economic interest."

A column in *Fortune* magazine openly gloated about the likely Senate roadblock to any increase in taxes on the private equity firms: "In another era, this might be a slam dunk for populist-minded Democrats: A new class of billionaires doesn't pay the same tax rates as ordinary Americans, leaving tens of millions of dollars more in their pockets to spend on private helicopters and ivy-clad boarding schools and Nantucket summer homes. What better example of Republicans favoring the rich? But wait: These new Greenwich/Manhattan billionaires happen to be donors, friends, and constituents of Democrats—not Republicans."

Most of the Democratic presidential candidates, including Hillary Clinton, Barack Obama, and John Edwards, have declared their support for closing the private equity loophole, in order to posture as friends of the working class and opponents of privilege for the wealthy.

The *Fortune* comment applauded the cynical division of labor between the presidential candidates and their Senate colleagues: "In the end, the powerful Dodd-Schumer duo could put the kibosh on the tax increase proposal, giving the party the best of both worlds, at least for now: Democratic presidential candidates who continue to issue populist appeals to tax the rich, and a Democratic Congress that leaves its new friends alone."