# Getting Away With Murder

Clifford Asness
Managing and Founding Principal
AQR Capital Management, LLC

Sept 22, 2015

Published version here

Calls to tax hedge funds more have long been a staple of the Left and now appear in the tax proposals of several leading republican candidates, either explicitly, or implicitly by equalizing many tax rates. Advocates for this change have long had some fair points but occasionally try to cheat by slipping in some clearly unreasonable ex post wealth grabs along with otherwise reasonable proposals. Now Donald Trump has entered into the long-standing debate with the characteristically specific statement “hedge fund guys are getting away with murder.” He often goes on to mention that he is “friends” with some of the hedge fund managers he’s targeting, presumably to bolster our belief in his courage and honesty – I mean, he’s standing up to friends! We’re also assured, using his now familiar verbal tics, that his still forthcoming tax plan will end this unpunished murder, and do many other wonderful things. He says his plan will be “great” and “huge.” Again, much of this debate, ex-The Donald, is reasonable and it is indeed a difficult issue. But, as usual, The Donald is different, taking it up more than a notch in empty dangerous rhetoric. His amps definitely go to eleven.

During his diatribes The Donald often adds in the standard populist canard against “paper pushers” in favor of people who “build things.” This accusation has a many-thousand-year pedigree (the Babylonians building Ziggurats said it about their Assyrian bankers) and has usually been wrong, always exaggerated, and occasionally downright ugly in its tone and targets – though admittedly often effective demagoguery. “Real” vs. “paper” is a topic for another day but I can’t help wondering whether Trump actually still “builds things” or mostly just licenses his name to things, ironically a form of “paper pushing.” Yes, I’m saying to The Donald “you didn’t build that Trump Eau de Toilette.”

Of course, like most things The Donald weighs in on, this issue is way more complicated than he lets on. Complication is too often a casualty in the political arena but it’s even less Donald’s forte than most. In fact, with The Donald sometimes you have to struggle to even understand what he’s talking about! We will have to take some educated guesses. The main issue usually debated regarding hedge fund taxation is about what’s called “carried interest.” For the sake of sanity, I’m going to assume this is what he’s referring to, that he thinks the “carried interest loophole” should be closed. If, rather, he’s just using the words “hedge fund manager” as a proxy for rich people and engaging in some type of weird class warfare, things are even farther gone.

The “loophole” (not everyone thinks it’s a loophole) is that right now some of a hedge fund manager’s remuneration, that part representing long-term capital gains structured as a carried interest, is taxed at the capital gains rate (people like Trump talk about “hedge funds” even though this is a far bigger issue for private equity funds). Some argue this capital gains treatment is appropriate as money is at risk, and beneficial as it encourages investment, and that it is consistent with taxation of employee incentive stock options and professional partnerships. Some counter that the first argument is bad accounting and the second “voodoo economics.” The third argument only interests tax nerds, because looking for consistency in the tax code is like looking for humility in The Donald.

This is not an op-ed taking either side of this argument. In fact one could take either side particularly on the accounting. That’s exactly what makes this issue hard. As a matter of proper accounting theory (do I still have your attention after that grabber?) it’s not difficult to argue for either case. There are indeed issues where honest people can come to different conclusions and this is one of them. Decisions like this, without a clear right and wrong, but where a choice must be made, will always be made by political means rather than one side convincing everyone else. Personally, when there is no clear right and wrong, I’m ok with the political process making the decision (full disclosure – most of what I do is traditional asset management not “hedge fund management” and certainly not private equity so this all only applies to me in a very small way; thus, like so many others, when I magnanimously concede that this issue could go either way, I’m mostly agreeing to consider taxing other people more).

So, all is good right? The Donald wants to close the “carried interest loophole” and I think there’s a real case to be made for that (as do some candidates on both sides of the aisle). Not so fast. There is a lot about Trump’s particular brand of attack that isn’t good at all.

Historically those railing about carried interest have run into a problem. When they come up with specific plans to tax it, they find it’s a much smaller issue, in actual dollars, than they thought or, more importantly, implied to their public. For instance, it's not, as the very confused New York Times says, simply a lower tax rate (capital gains vs. income) applied to a hedge fund manager's entire fee. It's a far smaller issue than that. It applies only to long-term capital gains earned by a partnership—any partnership, not a special rule for hedge funds—that are passed through to the general partner. The difficulty is these pass-through gains are both income, the general partner receives them for work performed, and long-term capital gain, the result of selling a successful long-term investment. Current tax law treats them as the latter, critics want the rules changed to the former. Like I said earlier, an argument can be made either way. But most hedge fund managers do not pay capital gains tax on the bulk of their income. Rather, they pay mostly at ordinary income tax rates. Thus “fixing” this issue, even if that were clearly and noncontroversially correct, does not generate very much in new revenue. That’s a problem for those wanting to use this tax change to fund other goals, or simply an embarrassment if they get asked what their populist crusade will accomplish (We got the bastards! That’s eleven dollars and fifty cents they won’t have to buy modern art anymore!).

What many populist tax crusaders have done in the face of this math is add to their proposals an “enterprise value tax” or EVT. There have been many proposals of this type and they are hard to characterize precisely as they evolve and morph looking for their opportunity to become law. Speaking generally, when owners sell the businesses they spent a working lifetime building, the sale is typically taxed at the capital gains rate. Under an EVT, only for certain types of businesses, this sale would instead be taxed at the much higher ordinary income rates. Ironically, that means owner-builders pay tax at a higher rate than pure investment owners (“paper pushers”) investing in the same business. Early EVT proposals subjected business partnerships with historical carried interest to this adverse treatment. Recent proposals narrow it to businesses dubbed “investment service partnerships” but now subject all of them to the higher tax rate regardless of whether or not they had ever benefited from the preferential treatment.

You’re right to be confused at this point. But, all EVT proposals share the same unsavory characteristics. They are essentially a large ex post wealth tax on any business the law’s backers think were too lightly taxed in the past. Of course, in most of the proposals the EVT hits many small businesses other than “hedge funds.” That’s dog-bites-man by now for activist politicians who have perfected the tactic of “target an unpopular group in rhetoric but hit a much wider group in fact.”

To be fair, we have not yet seen The Donald’s “great” and “huge” tax plan but when it’s finally released, in 20 foot gold (painted) letters of course, look to whether it includes this now standard trick of discussing carried interest taxation but raising its real revenue from the unreasonable and unprincipled EVT. I’d love to be proven wrong and find out The Donald’s plan addresses only carried interest itself going forward. But given that the full-on EVT is where the money is, and his plan is going to be “huge,” that’s not what I’d bet on. It’s also why this worry applies particularly to Trump. Those who soberly say “we should raise the tax on carried interest as that’s what I believe is fair” are on solid, if still arguable ground. There’s no logical reason for them to add in a giant wealth-expropriating EVT. But one who bombastically attacks “hedge funds” and “paper pushers” and promises something “huge” seems to be an obvious candidate to choose the only way this issue can turn out “huge,” by adding the very unreasonable EVT.

Speaking of The Donald’s attempt to bolster his populist anti-Wall street cred by attacking “hedge funds” it too is not ok, EVT or no EVT. Again, the issue of carried interest is an absolutely fair one to debate. But you’re being fooled if you believe the Donald is really opening or even engaging in this debate. Rather, The Donald is catering to the approximately one-third of the republican primary electorate that is angry, including not just at the usual subjects of right-wing ire, but at “Wall Street.” Instead of addressing that often valid anger with reasonable proposals, he throws out non-sequitur red meat about “hedge funds.” That’s small not huge.

It’s also not ok that he’s pretending to speak truth to hedge fund “friends” of his (another verbal tic, as if being labeled “a friend” of Trump’s in one of his many verbal parentheticals justifies all the invective he will assault you with – ask the Mexican people who he occasionally similarly parenthetically praises right after, well, you know). He wants to be seen as courageous for taking on his own, but he’s not really doing that. You know what might be courageous Donald? Tell us about how tricky tax arguments, including a fair amount of cronyism, have motivated so many big real estate transactions. Please tell us about the wide range of local tax credits, generous depreciation laws, and 1031 exchanges that allow real estate tycoons to "trade" properties up in value in near perpetuity sometimes without any tax toll (ironically, Bernie Sanders, more on Bernie below, proposes helping retirees and paying for it by partially closing this real estate tax “loophole”!) . Please tell us about real estate moguls’ propensity to refinance buildings to take out money without paying taxes. Tell us about those who literally pay zero taxes and, in fact, sometimes monetize tax credits. In fact, please show us your tax records, highlighting what you’ve paid due to real estate – not owning beauty pageants and mugging in reality TV – and how it compares to your wealth (which, yes, we know is vastly understated). If it turns out that your lifetime tax bill from real estate is tiny compared to your claimed wealth please tell us why that is ok, why you took that road, and how and why you're going to change the rules going forward. Now, I don't claim to be an expert on real estate taxation and perhaps, like carried interest, many of these things have two sides to them. But even cursory examination makes it clear that for a famous real estate developer to target "hedge funds" for "getting away with murder" (again, it's mostly private equity, not that they don't count!) and not address any of these, forgoes any claim to courage and honesty and plain-speaking of truth to power in favor of demagoguery,and exempting himself and others like him from any honest examination.

Courage isn't accusing already disliked groups of "murder." Courage is telling the people about stuff <u>you</u> have done, exploiting rules that <u>you</u> now think should be changed, even if it's to <u>your</u> detriment.

Frankly, if the roughly one third of the Republican primary electorate that currently seems to favor Trump really loves "anti-hedge fund" rhetoric, even if it's mostly inaccurate name calling, may I suggest those voters consider supporting Bernie Sanders who is presenting, if anything, an even bigger problem to the Democrat "establishment" than Trump to the Republican one? Bernie is even more anti-hedge fund than The Donald (and about as inchoate in explaining it). Bernie is fairly anti-immigrant (he's more compassionate than The Donald but is very big on "they're stealing our jobs!"). Bernie is even pro-gun. Paraphrasing a Seinfeld-ism, "he's got it all baby!" Oh, there's one thing that might make switching to Bernie awkward for the big part of the right wing currently enjoying the summer of The Donald: Bernie's an avowed socialist who wants a much bigger government. That's cool too, no? After all, Donald was pretty far left before he put his hand on a rock several months ago and said "I am a conservative!" Maybe Bernie will similarly convert?

Clearly many people on both sides of the aisle today are angry and people like Trump and Sanders are tapping into that in a big way. Much of that anger, probably on both sides, is at least somewhat justified. For instance, we do have a tax code riddled with complexity and cronyism. But we shouldn't be just targeting the unpopular with simplistic populist labels but tackling the actual issues. If the carried interest deduction goes away, ok, so be it. If that's deemed fair, or simply the price for simplification, more overall fairness, and less distortive cronyism, it's a small price matter no matter who is slightly more right on the accounting theory. But, Donald, let's keep our eyes on the prize here – making our tax code better and fairer – and not just utter easy ersatz-courageous slogans to the angry and pretend you've done something "great" and "huge" when all you've done is something shallow and shameful.