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POLICY NOTE

The Economic Impact of an Enterprise Value Tax

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***Note:** Congress is considering imposing an Enterprise Value Tax that would have a lasting and harmful impact on Washington's business climate. This Policy Note is adapted from a study written by economist J. Scott Moody of The Maine Heritage Policy Center and shows how this tax would affect business partnerships and private-sector investment. The full study analyzes how the Enterprise Value Tax would impact one state, Maine, and is available at www.mainepolicy.org.*

In legislation backed by Congressional Democratic leadership last year, there was an attempt to more than double the taxation on the sale of many businesses.[1] A provision in that legislation, known as the "Enterprise Value Tax," would have changed the federal taxation on a sale of any business structured as a partnership from a capital gains rate of 15% to ordinary income rates. Under the proposed legislation, entrepreneurs and family members owning small businesses other than family farms would no longer qualify for the 15% capital gains treatment upon the sale of their business if the entity held any form of partnership interest, interest income, investment real estate or securities.

The Enterprise Value Tax, or EVT, passed in the House of Representatives in 2010 as part of "H.R. 4213: American Jobs and Closing Tax Loopholes Act," and is a part of President Obama's proposed American Jobs Act now before Congress.[2] The adoption of an Enterprise Value Tax would be especially damaging to Washington businesses and economy for the following key reasons:

- A large portion of Washington businesses are structured as partnerships
- The imposition of an EVT would pull money out of the private sector, reducing working capital that would be better used to expand an already anemic economy
- Many Washington lawmakers are proposing to close loopholes and stabilize revenues through reform of the state tax system — an effort that would be thwarted by an Enterprise Value Tax imposed at the federal level

For these reasons, Washington state policymakers should oppose a federal EVT due to the economic damage it would inflict on Washington's local businesses and residents.

Partnerships are an important segment of America's economic and

[1] See H.R. 4213, the "American Jobs and Closing Tax Loopholes Act of 2010" sponsored by Senator Max Baucus (MT) and Representative Sandy Levin (MI).

[2] On May 28, 2010, the House passed H.R. 4213, the "American Jobs and Closing Tax Loopholes Act of 2010," by a vote of 245-171. On June 16, 2010, by a vote of 45-52, Senate Leadership failed to garner enough votes on a procedural motion to waive a budget point of order to move forward with consideration of Senate Finance Committee Chairman Max Baucus's substitute amendment to H.R. 4213. Following the failed procedural motion to waive a budget point of order, Chairman Baucus introduced a modified version of the substitute amendment. For a summary of Modifications and Additions Made to the Baucus Substitute Amendment to H.R. 4213 dated June 16, 2010 as well as the Legislative Text of the Senate Substitute Amendment to H.R. 4213 dated June 16, 2010 see www.finance.senate.gov/legislation/details/?id=1c237e70-5056-a032-52e9-ef5f959b7a76.

business landscape. According to business data from the United States Internal Revenue Service, in 2007 there were 3.1 million partnerships consisting of 18.5 million partners with $20.4 trillion in assets and nearly $10 trillion of equity.[3] By 2010, the IRS estimates the number of partnerships will swell to 3.8 million, including thousands located in Washington state.[4]

According to the United States Department of Treasury, the original intent of a capital gains tax was to take into account that an entrepreneur's income is not guaranteed but rather it is subjected to certain risks that the individual must bear.[5] Congress' proposed EVT legislation would no longer take into account this entrepreneurial risk and would significantly increase the tax burden on most partnerships when they are sold. The EVT proposal is written so broadly that it would sweep up partnerships and most family businesses, many of which are unaware they are facing a potentially large new tax on the accumulated value of their working careers.

The Enterprise Value Tax

The EVT is a derivative and substantial extension of the proposal to increase the tax rate on "carried-interest" income for partnerships.[6] Proponents of the Enterprise Value Tax, in an attempt to claw back any prior favorable treatment of "carried-interest" income (the name for an accounting practice used to distribute revenue to general partners of certain types of partnerships), worried that general partners of businesses may try to sell their interests and capitalize on existing favorable tax treatment. Carried interest, however, has nothing to do with the sale of a business, the vast majority of which view capital gains treatment of carried-interest income as purely incidental and irrelevant to the value of the business itself. However, this tenuous link to carried interest has obfuscated the effect of the EVT, which casts a far broader net.

The EVT would tax the gain of a partnership at the time of sale at a blended federal ordinary income tax rate that is much higher than the capital gains rate of 15%. As the provision was written, the EVT would be triggered by the sale of any partnership interest that at any point generated even $1 in carried-interest income. As a result, many unsuspecting partnerships will be ensnared by the EVT.

Under current law, most of the gains from the sale of a partnership are taxed at the capital gains rate consistent with the general rule that business interests should be treated as capital assets. The EVT, if adopted, would limit the amount taxable under the capital gains rate to between 25% (for assets held five years or less) and 50% (for assets held more than five years) with the remainder being taxed at ordinary income tax rates. This represents a very substantial jump in tax rates, a jump that would be much higher under already-scheduled future income tax rate changes, as seen the table that follows.

[3] U.S. Internal Revenue Service business data and economic characteristics on partnerships can be found at www.irs.gov/taxstats/bustaxstats/article/0,,id=97127,00.html.
[4] IRS projections for partnership filings can be found at www.irs.gov/pub/irs-soi/d6149.pdf.
[5] Testimony of Eric Solomon: "Unlike employees and independent contractors, a partner has a stake in the business with rights and obligations that vary depending upon the terms of the partnership agreement. While compensation of employees and independent contractors is typically fixed and payable regardless of the success of the business, a partner's distributive share of partnership income is subject to the entrepreneurial risks of the partnership's business." Available at www.ustreas.gov/press/releases/hp489.htm.
[6] For more information on taxation of "carried interest," see: Holtz-Eakin, Doug, "The Tax Treatment of Carried Interest," American Action Forum, June 2010, at www.americanactionforum.org/files/TaxTreatmentCarriedInterest.pdf.

Blended Rate Scenarios			
	Current Law	Under Expired Bush Tax Cuts	Under Medicare Investment Surtax
Blended Rates (a)	30.0%	34.7%	38.5%

(a) Assumes long-term capital gains rate (over one year) and short-term EVT holding period (less than five years)

For short-term holdings under the EVT of five years or less, the sale of partnerships would face a federal tax rate of 30% under current law.[7]

Furthermore, in future years the blended rate could go much higher if the Bush tax cuts expire as scheduled, resulting in a blended rate of 34.7%.[8] And, under the new federal health care bill passed this year, a 3.8% Medicare tax will be levied against taxpayers' investment income.[9] As a result, the blended Federal rate will be much higher at 38.5% in 2013 and beyond when this new Medicare investment surtax kicks in.[10]

Nationally, under current law, partnerships anticipated to become subject to the EVT currently pay $19.4 billion in federal capital gains taxes annually. Under the EVT, federal taxes paid on capital gains paid would double to $38.7 billion. Adding the impact of the expiration of the Bush tax cuts, federal capital gains tax on these partnerships would rise to $44 billion and to $50 billion when the Medicare investment surtax is added.

Conclusion

The implementation of a federal Enterprise Value Tax would extract millions from Washington's economy every year, capital that would be better used by Washington citizens to continue to expand their real estate, finance and manufacturing businesses, including innovative high-tech and natural resource-based industries that are crucial to the state's economic recovery. Adoption of an EVT would pull money out of the private sector that is needed for capital investment and to expand the state's tax base. Finally, the proposed EVT is at odds with proposals by Washington lawmakers to close loopholes and reform the state tax code.

Overall, Washington state policymakers should oppose a federal EVT due to the economic damage it would inflict on Washington businesses and citizens.

J. Scott Moody is Chief Economist at The Maine Heritage Policy Center. He is the author, co-author and editor of over 140 studies and books. He has testified twice before the House Ways and Means Committee of the U.S. Congress as well as various state legislatures. His professional experience includes positions as Senior Economist at The Tax Foundation and Senior Economist at The Heritage Foundation.

[7] [(25% x 15% capital gains rates) + (75% x 35% ordinary income tax rate)].

[8] [(25% x 20% capital gains rates) + (75% x 39.6% ordinary income tax rate)].

[9] Single taxpayers who earn more than $200,000 and married taxpayers with combined income of more than $250,000 would face the new tax on their investment gains starting in 2013.

[10] [(25% times 23.8% capital gains rates) + (75% x 43.4% ordinary income tax rate)].