

*The Enterprise Value Tax:
What it Means for the
Massachusetts Economy*

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Executive Summary

President Obama's Plan for Economic Growth and Deficit Reduction contains a provision that would tax, as ordinary income rather than capital gains, the net proceeds from the sale of what is deemed an "investment services partnership interest" (ISPI). An ISPI is any interest in an investment partnership that is acquired by a person as a result of activities involving the purchase and sale of certain "specified assets," defined to include partnership interests, securities and real estate holdings.

This provision, which is labeled as the "Enterprise Value Tax" (EVT), would force certain partnerships to pay ordinary income tax on the sale of any part of their business. Although publicly touted as a tax on financial firms, the EVT will have broad sweeping impact on other industries such as natural resources, real estate, and many other businesses. The EVT represents an important departure from current law.

Under current law, most of the profits from the sale of investment partnerships are taxed at the capital gains rate, consistent with the long-standing general rule that business interests should be treated as capital assets. The tax rate on long-term capital gains is 15%. The EVT would treat these same profits as ordinary income, for which the top statutory tax rate is 35%.

The purpose of this study is to assess the effects of this change on the Massachusetts economy. The implications for Massachusetts are potentially severe, considering that the state is a center for venture capital and the incubation of high-technology businesses. The plan would be particularly punishing toward the financial, insurance and real estate (FIRE) sector, which comprises 25% of the state's economy.

We predict that persons who reside in Massachusetts will pay \$611 million annually in new federal taxes under the plan. Using our State Tax Analysis Modeling Program, (STAMP), we also find that, as a result:

- The state will lose 5,400 jobs.
- Annual capital spending will fall by \$9.5 million.
- Residents' real disposable income, or income available for spending and saving, will fall by \$673.2 million.

These results are consistent with the argument from economics that a tax on capital income discriminates against saving and risk taking. By reducing saving, the tax reduces investment and employment, thus also reducing income and that part of income (i.e., disposable income) that is available to finance consumption. By reducing risk taking, the tax discourages innovation and, with it, technical progress, with further negative effects on investment, productivity, employment and income. These effects are likely to be especially severe for states like Massachusetts whose economies are centered on financial services and high technology.

Introduction

The President's Plan for Economic Growth and Deficit Reduction contains a provision that would tax, as ordinary income rather than capital gains, the net proceeds from the sale of an "investment services partnership interest" (ISPI). An ISPI is any interest in an investment partnership that is acquired by a person as a result of activities involving the purchase and sale of certain "specified assets," defined to include partnership interests, securities and real estate holdings.

Because the top statutory tax rate on ordinary income is 35% while long-term capital gains are taxed at 15%, the President's plan in effect imposes a new tax. This new tax has been dubbed the "Enterprise Value Tax (EVT)."

The idea of an EVT is an offshoot of Congress's attempt to tax "carried interest" as ordinary income. Carried interest, a separate issue from EVT, is a capital gain that a partner in a firm receives from the sale of some asset managed by the firm. Proposals to tax carried interest became popular a few years ago in response to growing resentment toward Wall Street and the need to reduce the burgeoning federal deficit.

The EVT goes further. In part to discourage tax avoidance that could be expected to occur in response to the new tax on carried interest, the EVT taxes gains on the sale of an ISPI that has as little as one dollar in carried interest. Only certain narrowly defined partnerships and sales of "qualified capital" would be exempt.

Proponents of the EVT claim that it closes a loophole in the tax code. Opponents describe it as a fundamental change in the tax laws that does not comport with long-established precedent.

It is important, in considering the economic effects of the plan, to understand that every attempt to close a loophole amounts to the imposition of a new tax. The EVT is no exception. The question is how the economic effects of the new tax compare to the additional revenue it yields. This new tax would fall particularly hard on Massachusetts, which trails only California in the dollar volume of venture capital per person.¹

¹ Latest figures culled from PricewaterhouseCoopers/National Venture Capital Association MoneyTree 3rd Quarter 2011. For a broader view of performance see Massachusetts position in the "Business Incubation Subindex" in the *Tenth State Annual State Competitiveness Report*, 36 (The Beacon Hill Institute at Suffolk University, Boston: 2010) <http://www.beaconhill.org/Compete10/Compete2010State.pdf>. (accessed November 14, 2011).

Massachusetts has 169,000 partnerships and corporations filing under Subchapter S of Chapter 1 of the Internal Revenue Code.² The number of these companies in Massachusetts is expected to grow by more than 4.1 percent through 2017, outstripping the national average of 3.8 percent.³ The EVT is targeted at a large portion of these companies.

As mentioned, the maximum statutory tax rate is 35% on ordinary income (i.e., wages) but 15% on long-term capital gains. The justification for this preferential treatment of capital gains lies in the long-established economic proposition that any tax on the earnings of capital discriminates against saving and risk taking. The taxpayer pays once when he earns his income in the form of wages and then a second time when he gets a return on that portion of his wages that he saves by, say, providing funds to start up or restructure an enterprise.

Taxpayers who use a portion of their wages to start a new venture (or to build value in a venture that they acquire) are sacrificing current consumption and taking on risks for which any future return is the hoped-for reward. To tax them on that reward is to subject them to a penalty that they could escape by consuming rather than saving. The reason why the law gives preferential treatment to capital gains is to reduce the discrimination against saving and risk taking to which this penalty gives rise.

While the popular conception is that the preferential treatment of capital gains amounts to a giveaway to rich fund managers, the economic reality, therefore, is that *any* tax on the return to capital, including capital managed by the finance industry, is a double tax that discourages saving and investment. This explains why legislators have long provided for the preferential treatment of capital gains, as well as other capital income, including dividend income and savings placed in pension funds.

The practice of according preferential treatment to capital gains has a nonpartisan history. By raising the tax on a portion of the capital income of general partnerships, the EVT does not, therefore, close a "loophole" at all. The preferential treatment of capital gains, however defined, is not a glitch in the tax code that nobody noticed until now or that is there because of one political party's disposition to favor investment managers. The preferential treatment of capital gains is based on a policy decision to reduce the penalty on investment and risk taking.

The EVT will therefore have negative economic effects on investment and job creation that the capital gains law was intended to avoid. Any consideration of the EVT must weigh these effects against the new revenue that it will yield. An increase in the tax rate on capital gains, as applied in particular to investment firms such as hedge funds and private equity funds, will have negative effects on investment and job creation.

² U.S. Internal Revenue Service, Statistics of Income, "Table 2. Individual Income and Tax Data, by State And Size of Adjusted Gross Income, Tax Year 2009,"

<http://www.irs.gov/taxstats/article/0,,id=171535,00.html>. (accessed November 16, 2011).

³ U.S. Internal Revenue Service, "Calendar Year Return Projections by State," Document 6149 (Rev. 11-2010) <http://www.irs.gov/pub/irs-soi/d6149.pdf> (accessed November 18, 2011).

The EVT doubles the tax on the portion of capital income on which it is to be imposed. It will, in the process, discourage the formation and growth of partnerships, especially in the Finance, Insurance and Real Estate (FIRE) sector, which comprises 25% of the state's economy. As a state that maintains its competitiveness by nourishing venture capital and innovation, Massachusetts is particularly ill-disposed to absorb this hit on its economy.

The Impact of the EVT on Massachusetts

We used two measures to determine the economic effects of a federal EVT. First, we modeled the national tax impact of the EVT by drawing on data from the Internal Revenue Service and the Bureau of Economic Analysis (BEA). Second, we used our STAMP model to simulate how the Massachusetts economy might respond to the change. Table 1 displays results based on the data sources listed above for the U.S. and Massachusetts.

Table 1: Tax Impact of the Enterprise Value Tax for Calendar Year 2012 (\$ millions)

Top Capital Gains Tax Rate ^a	Capital Gains Taxes Paid		Capital Gains Taxes Paid with EVT Tax		Net Tax Increase	
	National	Massachusetts	National	Massachusetts	National	Massachusetts
30.0%	\$19,828	\$611	\$39,656	\$1,221	\$19,828	\$611

^aThe top capital gains tax rate is a blended rate, weighted 25 percent toward the capital gains rate and 75 percent toward the ordinary income tax rate. See "Methodology" section.

Currently firms generate \$19.828 billion in federal capital gains taxes, annually. Under the EVT, federal taxes paid on capital gains paid would double to \$39.656 billion.

In Massachusetts, partnerships that would be obligated to pay EVT currently pay \$611 million in capital gains taxes annually. If the EVT were in effect during 2012, capital gains paid by Massachusetts partnerships would double from \$611 million to \$1.221 billion.⁴

The tax law change would ripple through the state's economy since firms covered by the EVT would adjust their behavior by reducing investment and employment, with further ripple effects on income and disposable income.

To determine the effects of the EVT on the Massachusetts economy, BHI used its State Tax Analysis Modeling Program (STAMP).⁵ Massachusetts-STAMP is a five-year dynamic

⁴ Proposals similar to the EVT go back several years and have different (or unspecified) target years. We use 2012 as a target year because it is as close as practical to the most recent year for which we could get data, which was 2008.

⁵ For a description about the STAMP model see http://www.beaconhill.org/STAMP_Web_Brochure/STAMP_HowSTAMPworks.html.

Computable General Equilibrium (CGE) model that simulates the economic effects of changes in taxes, costs (general and sector specific) and other “exogenous” changes. As such, it provides a mathematical description of the economic relationships among producers, households, governments and the rest of the world. It is general in the sense that it takes all the important markets, such as the capital and labor markets, and flows into account. It is an equilibrium model because it assumes that demand equals supply in every market (goods and services, labor and capital). This equilibrium is achieved by allowing prices to adjust within the model. And it is computable because it can be used to generate numeric solutions to policy and tax changes. Table 2 displays our results.

Table 2: The Effects of a National EVT on the Massachusetts Economy

Massachusetts Economic Variables	2012
Employment (jobs)	-5,400
Investment (\$ millions)	-\$9.447
Real Disposable Income (\$ millions)	-\$673.196

The STAMP simulations show that the EVT would eliminate 5,400 jobs. The tax increase, combined with the job losses, would reduce real (inflation-adjusted) disposable income in Massachusetts by \$673.196 million. The EVT would also reduce the after-tax return on capital investments by partnerships. As a result, investment would become less attractive to partnerships, and investment in Massachusetts would fall by \$9.447 million.

Methodology

BHI modeled the tax impact of the EVT by drawing on data from the Internal Revenue Service (IRS) and the Bureau of Economic Analysis (BEA). The IRS provides extensive details on partnerships by industry (using the North American Industry Classification System) and taxable capital gains and losses from the sale of capital assets.

To project the amount of revenue that the EVT tax would generate for the federal government, we need to estimate the tax base or the enterprise value subject to the EVT. We start with the \$9.092 trillion in total enterprise value of partnerships listed on the “Partners Capital Accounts” row from the IRS Statistics of Income (SOI), “Table 3. All Partnerships: Balance Sheets, by Profit Status and Selected Industrial Group, 2008.”⁶

⁶ U.S. Internal Revenue Service, *Statistics of Income*, “Table 3: All Partnerships: Balance Sheets, by Profit Status and Selected Industrial Group, 2008,” <http://www.irs.gov/taxstats/bustaxstats/article/0,,id=97127,00.html>.

In addition to enterprise value, the IRS collects detailed statistics on capital gains transactions by asset type. The capital gains information allows us to anchor the total enterprise value data to actual taxable sales of partnerships. We use the lines labeled “Partnership, S corporation, and estate or trust interests” and “Passthrough gains or losses” from SOI “Table 1a. Short-Term and Long-Term Capital Gains and Losses, by Asset Type.”⁷ According to the IRS, passthrough gains “reflect gains from sales of capital assets by partnerships, S corporations, or fiduciaries that are reported and taxed on individual income tax returns.”⁸

The table for 2007 shows \$134.611 billion in sales at a cost basis of \$86.074 billion, for a net gain of \$49.145 billion. The passthrough numbers show only the gains and not the basis or the price sold. We use the ratio of net gains to sales and price for Partnership, S corporation, and estate or trust interests to estimate a cost basis for passthrough gains as \$642.614 billion.

Because the IRS does not break out the data any further, we use total assets as a proxy to estimate sales attributable to partnerships. For trusts, we impute total assets using income and the ten-year U.S. Treasury bond rate.⁹ Partnerships account for 61.6% of the assets of the four entities (partnerships, S corporations, and estate or trust interests). We therefore compute the cost basis for partnerships and passthrough partnerships combined as 61.6% of their combined cost basis of \$728.688 billion (= \$86.074 billion + \$642.614 billion) to arrive at \$448.653 billion.

We estimate the percentage of partnership interests that will be sold in 2012 by dividing the cost basis (\$448.653 billion) of the assets sales in 2008 by the total value of the partnership assets (\$9.092 trillion). The result gives us a turnover rate of 4.9%. We consulted financial industry experts, and they estimated that annual turnover would be about 5% to 10%. On that basis, we believe our estimate to be conservative.

We inflate the 2008 data to 2012 using the inflation forecast from the Congressional Budget Office, or 4.51% compounded over the period.¹⁰ As a result, the total value of the partnership assets grows to \$9.51 trillion, and the cost basis of the assets sold grows to \$469.069 billion.

⁷ U.S. Internal Revenue Service, *Statistics of Income*, “Table 1a: Short-Term and Long-Term Capital Gains and Losses, by Asset Type,” <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96649,00.html>.

⁸ Janette Wilson and Pearson Liddell, U.S. Internal Revenue Service, *Statistics of Income Bulletin*, “Sales of Capital Assets Reported on Individual Tax Returns, 2007,” <http://www.irs.gov/pub/irs-soi/10winbul.pdf> (Washington D.C) 75.

⁹ U.S. Internal Revenue Service, *Statistics of Income Bulletin*, “Figure D: S Corporation Total Assets, Total Receipts, and Total Net Income (Less Deficit), by Industrial Sector, Tax Year 2007,” <http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96405,00.html>, “Domestic Private Foundations and Charitable Trusts: Selected Financial Items and Percentage Changes, Tax Years 2004-2006,” <http://www.irs.gov/pub/irs-soi/09fallbulfoundtrusts.pdf>, Table 1 - Selected Data from Forms 706 Filed in 2008 and from the Form 1040 Filed by the Decedent in the Year Prior to Death, Individuals with a Married {and non-married} Form 1040 Filing Status, by Tax Status and Size of Gross Estate, <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=245877,00.html>.

¹⁰ The U.S. Congressional Budget Office, *Budget and Economic Outlook: An Update, Detailed Economic Projections, CY 2011-2021; Actual Data, 1950-2009*, <http://www.cbo.gov/doc.cfm?index=12316>.

Enterprise value does not represent the full price that partners receive in the marketplace for their stake. Thus, we need to calculate a sales price for the partnerships assets or a price-to-book-value ratio. We use the IRS data from above and divide the value of sales from partnerships (\$134.611 billion) by the cost basis of those sales (\$86.074 billion) to obtain our price-to-book-value ratio of 1.56. We then multiply our 2012 average price-to-book-value ratio by the \$469.069 billion in assets sold, which results in a sales price for partnership assets of \$733.578 billion and subtract the cost basis of the assets, or \$469.069 billion, for total net capital gains of \$264.508 billion.

Next, we estimate the portion of these gains that would be subject to the EVT and which sectors would be affected. Because the language in the President's Plan for Economic Growth and Deficit Reduction is vague and the CBO and OMB do not score the EVT individually or provide details, we assume that half of the gains (50 percent) would be subject to the EVT, or \$132.254 billion.

We estimate Massachusetts' share of taxable gain on sales to be 3.08%, based on the BEA's estimate of the state's share of private earnings by industry. This figure corresponds closely to Massachusetts share of U.S. partnership and S-Corp income, at 2.95%.¹¹ Thus, we estimate Massachusetts taxable gain on sales to be \$4.073 billion in 2012.

We also assume that the top capital gains tax rate is a blended rate, weighted 25% toward the capital gains rate and 75% toward the ordinary income tax rate. The estimated increase in the capital gains tax liability under the EVT is derived by multiplying the taxable gain on sales by the blended rate under the two scenarios and taking the difference. The estimated increase in taxes paid by Massachusetts residents is \$611 million.

The estimated tax impact of the EVT is dependent on the validity of the assumptions used in the model. Given the judgment that went into making some of these assumptions, we thought it useful to subject our estimates to sensitivity analysis. Table 4 displays the results of this analysis. The top panel of the table shows that a one-percentage-point increase in the turnover rate increases the U.S. tax impact to \$24.123 billion while a one-percentage-point decrease in the turnover rate reduces the U.S. tax impact to \$16.082 billion.

The next two panels of Table 4 show the impact of changing the percentage of capital gains that would be subject to EVT and of changing and the price-to-book-value ratio. The table shows that a 25-percentage-point increase in the enterprise value impacted yields an increase in the U.S. tax impact to \$29.757 billion. Conversely, a 25-percentage-point decrease in the enterprise value impacted yields a decrease in the U.S. tax impact to \$9.919 billion. If we increase the price-to-book ratio from 1.6 to 2.1 the U.S. tax impact increases to \$37.428 billion while if we reduce it to 1.1 the result is a drop to \$2.248 billion.

¹¹U.S. Internal Revenue Service, *Statistics of Income Bulletin*, "Table 2. Individual Income and Tax Data, by State And Size of Adjusted Gross Income, Tax Year 2008otal Assets, Total Receipts, and Total Net Income (Less Deficit), by Industrial Sector, Tax Year 2007," <http://www.irs.gov/taxstats/article/0,,id=171535,00.html> (accessed November 18, 2011).

The last panel in Table 4 shows the effects of alternative assumptions about weighing the capital gains rate and the ordinary income tax rate in computing the blended rate. If we assume a blended rate of 10% capital gains and 90% ordinary income, the U.S. tax impact rises to \$23.806 billion. If we assume a blended rate of 50% capital gains and 50% ordinary income the EVT tax impact falls to \$13.225 billion.

Table 4: Sensitivity Analysis of the Enterprise Value Tax for Calendar Year 2012 (\$ millions)

New Assumptions	Current Capital Gains Taxes Paid		Capital Gains Taxes Paid with EVT Tax		Net Tax Increase	
	National	Massachusetts	National	Massachusetts	National	Massachusetts
Turnover Rate						
6%	\$24,123	\$743	\$48,245	\$1,486	\$24,123	\$743
4%	\$16,082	\$495	\$32,163	\$991	\$16,082	\$495
Price-to-Book Ratio						
2.1	\$ 37,428	\$1,153	\$74,857	\$2,306	\$37,428	\$ 1,153
1.1	\$2,248	\$ 69	\$4,496	\$138	\$2,248	\$69
Capital Gains Subject to EVT						
75%	\$29,757	\$917	\$59,514	\$1,833	\$29,757	\$917
25%	\$9,919	\$306	\$19,838	\$611	\$9,919	\$306
Blended Tax Rates						
90%-10%	\$19,838	\$611	\$43,644	\$1,344	\$23,806	\$733
50%-50%	\$19,838	\$611	\$33,064	\$1,018	\$13,225	\$407

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