Unpacking Mitt Romney's taxing problem
By Eric Schulzke
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Mitt Romney reluctantly agreed this weekend to release his 2010 taxes today, mainly because he was pummeled in South Carolina after he appeared detached and evasive on the matter. For days, he insisted he would not be cowed into releasing earlier than April.

His reluctance is understandable. Rarely does a candidate personally embody a policy debate such as Romney does now. His tax records will likely distract from his agenda while further stoking class warfare already at a fever pitch.

"People in this class tend to be very private, and it's more abstract when it's wealthy people whose names maybe you've heard," says Sam Brunson, who teaches tax law at the Loyola University School of Law in Chicago. "It's very different when you run for president."

Romney now finds himself buffeted by the Buffet rule, a populist position staked out by the super-wealthy Warren Buffet in 2011, who argues the super rich should pay more, a direct shot at the differential treatment afforded capital gains.

Romney is also on defense because he paid only 15 percent in federal taxes last year, while Newt Gingrich, who has already released his own taxes, paid roughly 31 percent, none of it capital gains.

But Romney's taxes actually embody a debate within a debate. The first question is whether capital gains should be taxed at a different rate than regular income. The second is whether managers (like Romney) of private equity firms (like Bain Capital) should qualify for capital gains treatment when they share in the profits generated by their funds.

Tracking the gap

"Capital gains," says Robertson Williams, a senior fellow at the Tax Policy Center, "is an increase in value of an asset held for some period of time." When these assets are sold, the income is taxed differently at 15 percent, or less than half of the top income tax rate of 35 percent for ordinary income. Because most capital gains are taken by the very wealthy, this difference in tax rates is Romney's first political problem.

Capital gains have not always been treated differently, Williams says. Both top marginal income taxes and capital gains have varied widely since the income tax began in 1913. Through most of the post-New Deal era, upper-bracket tax rates ranged from a high of 90 percent to a low of 50, while capital gains taxes hovered between 20 and 40 percent as tax formulas shifted.

Under the 1986 tax reform, the tax gap was erased. The highest income tax rate and capital gains now met in the middle at 28 percent. By 1990, the gap re-emerged and then grew as top rates climbed back to 35 percent and capital gains taxes fell to 15 percent. If the Bush tax cuts ever do finally expire, top taxes will bounce to 39.6 percent and capital gains to 20.
This instability hurts Romney as it means he sits on a burned, still-smoking battleground populated by the contending armies backing the Bush tax cuts and the Occupy Wall Street movement. In short, Romney becomes the reluctant personification of a long-standing, bitter and far-from-finished debate.

Assessing the difference

Economists differ on whether the difference is defensible, or what would happen if it disappeared. "Differential tax rates skew behavior," says Scott Condie, an economics professor at Brigham Young University. Condie points to current policies that favor certain high-risk startups with even more favorable capital gains treatment. "There is a question as to whether we encourage the right kinds of risk when we attempt this kind of surgical targeting," he says.

However, Condie adds that returning to the 28 percent split between top tax rates and capital gains would also change investor behavior, and not necessarily for the better. Condie predicts more consumption and a shift to safe, tax-free municipal bonds. "There would be less investment, but even still there would be more tax revenue. Whether it's worth the tradeoff is an empirical question, but one we will never have the data to answer." And in the absence of data, politics and ideology have free reign.

Piggybacking fund managers?

Romney's second challenge is that much of his capital gains income may come in a form that is a controversy within a controversy. Private equity firms such as Bain Capital reward partners (and sometimes former partners such as Romney) with a share of the profits from their funds, referred to as "carried interest" or just plain "carry."

But is carry ordinary income or is it capital gains? Watching this dispute is like watching contentious monks count angels on the head of a pin. It comes down to a dispute over whether the fund managers own a business in which investors invest, as urged by David Weisbach at the University of Chicago, or whether they provide a service and thus work for the investor, as argued by Victor Fleischer at the University of Illinois. As of now, the law comes down on the side of ownership and treats their profit-sharing as capital gains, hence taxed at the lower rate.

One investor interviewed for this article firmly disputed that there is even a real argument here. "A carry is not like cash payment for work performed. It's not guaranteed. It's an agreement to take a risk in lieu of cash with the possible benefit of an upside."

Whatever the merits of carried interest in tax law and theory, the large sums involved combined with the murkiness of the dispute create a political no man's land such that even if Romney followed the law scrupulously — as we expect he did — he would still find himself on defense. Which is just where Newt Gingrich wants him.