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**SQUEEZING ENTREPRENEURS**  
THE ECONOMIC IMPACT  
OF AN ENTERPRISE VALUE  
TAX IN NEW JERSEY

J. Scott Moody  
Adjunct Scholar  
Policy Report 50-10



## About the Author

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**J. Scott Moody** has worked as a Tax Policy Economist for over 13 years. He is the author, co-author and editor of 154 studies and books. He has testified several times before the House Ways and Means Committee of the U.S. Congress as well as various state legislatures. He has been interviewed by countless newspapers and radio and television stations. His work has appeared in Forbes, CNN Money, State Tax Notes, Portland Press Herald, New Hampshire's Union Leader, Hartford Courant, The Oklahoman and Albuquerque Journal.

His professional experiences includes a positions as Senior Economist at The Tax Foundation, Senior Economist at The Heritage Foundation, Vice President of Policy and Chief Economist at The Maine Heritage Policy Center, Research Fellow at The Oklahoma Council of Public Affairs, and Senior Fellow for Budget and Tax Policy at the Illinois Policy Institute.

Additionally, Scott was recently appointed by Maine's Governor to the prestigious Consensus Economic Forecasting Commission.

Scott received his Bachelor of Arts in Economics from Wingate University (Wingate, N.C.). He received his Master of Arts in Economics from George Mason University (Fairfax, VA)

## Executive Summary

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President Obama's Plan for Economic Growth and Deficit Reduction contains a provision, known as the "Enterprise Value Tax", that would increase the federal taxation on a sale of any business structured as a partnership from a capital gains rate of 15% to the ordinary income rates that now reach as high as 35%. Under the tax increase, 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 "specified assets" such as partnership interest, interest income, investment real estate or securities.

The adoption of an Enterprise Value Tax would be especially damaging to New Jersey's businesses and economy for the following key reasons:

- (1) A large portion of New Jersey's small businesses are structured as partnerships, 172,000 in 2012.
- (2) The imposition of an EVT will potentially extract \$349 million annually from New Jersey's economy, working capital that would be better used by New Jersey's current and future partnerships to expand an already anemic economy.
- (3) The EVT will negatively impact New Jersey's top industries: information, real estate, and finance. These three industries represent \$149 billion (31 percent) of the New Jersey economy. The EVT will extract nearly \$251 million from these three industries.
- (4) From a fiscal federalism standpoint, states that piggyback on the federal income tax code might also adopt the EVT; thereby, compounding the negative economic impact of this change in tax policy.

For these reasons, New Jersey's state and local policymakers, as well as its Congressional delegation should oppose a federal EVT due to the economic damage it would inflict on New Jersey's businesses and citizens.

## Introduction

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Partnerships are an important segment of America's economic and business landscape. According to business data from the United States Internal Revenue Service (IRS), in 2009 there were 3.169 million partnerships consisting of 21.1 million partners with \$18.8 trillion in assets and nearly \$9.7 trillion of equity.<sup>1</sup> By 2012, the IRS estimates the number of partnerships will swell to 4 million, of which 171,900 will be owned by New Jersey residents.<sup>2</sup>

According to the United States Department of Treasury, the original intention 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.<sup>3</sup> The President's Plan for Economic Growth and Deficit Reduction containing the EVT 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 provision 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.

This study examines the nature of the EVT, its tax impact nationally, as well as its magnified effect in New Jersey. This study also explores the EVT's fiscal federalism impact on the states. Finally, the study provides a methodological discussion of the model used to estimate the tax impact of the EVT.

## The Enterprise Value Tax

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The EVT is a derivative and substantial extension of the proposal to increase the tax rate on "carried-interest" income for partnerships.<sup>4</sup> Proponents of the EVT, in an attempt to claw-back any prior favorable treatment of "carried-interest" income (the name for an accounting practice that's 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 federal ordinary income tax rates that today reach 35%, 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 percent (for assets held less than 5 years) and 50 percent (for assets held for more than 5 years) with the remainder being taxed at ordinary income tax rates. This represents a very substantial jump in tax rates, a jump that will be much higher under already scheduled future income tax rate changes, as seen in Table 1.

For short-term holdings of less than 5 years, the sale of partnerships will face a federal tax rate of 30 percent under current law.<sup>5</sup>

Furthermore, as we move beyond 2013, the blended rate could go much higher if the Bush tax cuts expire as scheduled, and, under the new federal health care bill, a 3.8% Medicare tax will be levied against taxpayers' investment income.<sup>6</sup> As a result, the blended federal rate will be much higher at 38.5 percent in 2013 and beyond.<sup>7</sup>

***The Tax Impact: Information, Finance and Real Estate Hit the Hardest***

Table 1 shows the tax impact of the EVT nationally and for New Jersey under the two different capital gains tax rates—“Current Law” and “With Expired Bush Tax Cuts and Medicare Investment Surtax (see “Methodology” section below for more details of the model).<sup>8</sup> Although each of these tax rates applies to different time-periods, for comparative purposes, this analysis shows them as if they were in effect for 2011.

**Table 1  
Tax Impact of the Enterprise Value Tax  
Calendar Year 2011 (in millions of dollars)**

Top Capital Gains Tax Rate (a)		Capital Gains Taxes Paid		Capital Gains Taxes Paid Under EVT		Net Tax Increase	
		National	New Jersey	National	New Jersey	National	New Jersey
Current Law (Short-Term Holdings)	30.0%	\$11,133	\$353	\$22,267	\$706	\$11,133	\$353
With Expired Bush Tax Cuts and Medicare Investment Surtax	38.5%	\$17,665	\$560	\$28,576	\$906	\$10,911	\$346
<p>(a) The 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.</p>							
<p><b>Source: See Methodology section.</b></p>							

Nationally, under current law, partnerships anticipated to become subject to the EVT currently pay \$11.1 billion in federal capital gains taxes, annually. Under the EVT, federal taxes paid on capital gains paid would double to \$22.3 billion. Adding the impact of the expiration of the Bush tax cuts and Medicare investment surtax, federal capital gains tax on these partnerships would rise to \$28.6 billion.

In New Jersey, under current law, partnerships that would become subject to the EVT currently pay \$353 million in capital gains taxes, annually. Under the EVT, capital gains paid by New Jersey partnerships would have doubled to \$706 million. Adding the impact of the expiration of the Bush tax cuts and Medicare investment surtax, federal capital gains tax on these partnerships would rise to \$906 million.

Table 2 shows the distribution of the EVT by industry. Nationally, and in New Jersey, the three industries hit the hardest are “Information” (net increase \$2.2 billion nationally and \$77 million in New Jersey), “Finance and Insurance” (net increase \$1.9 billion nationally and \$67 million in New Jersey) and “Real Estate and Rental and Leasing” (net increase around \$3.1 billion nationally and \$106 million in New Jersey).

**Table 2:  
How the EVT Will Impact New Jersey Industries**

Industry	Current Law		With Expired Bush Tax Cuts and Medicare Investment Surtax	
	National	New Jersey	National	New Jersey
<b>Forestry, fishing, and related activities</b>	\$80.8	\$2.8	\$79.2	\$2.7
<b>Mining</b>	\$870.8	\$4.5	\$853.4	\$4.4
<b>Utilities</b>	\$144.2	\$0.0	\$141.3	\$0.0
<b>Construction</b>	\$158.8	\$5.9	\$155.6	\$5.8
<b>Manufacturing</b>	\$840.8	\$24.3	\$824.0	\$23.8
<b>Wholesale Trade</b>	\$289.4	\$6.5	\$283.6	\$6.4
<b>Retail Trade</b>	\$137.2	\$6.2	\$134.4	\$6.0
<b>Transportation and Warehousing</b>	\$221.5	\$7.4	\$217.1	\$7.2
<b>Information</b>	<b>\$2,215.4</b>	<b>\$77.6</b>	<b>\$2,171.1</b>	<b>\$76.1</b>
<b>Finance and Insurance</b>	<b>\$1,903.1</b>	<b>\$66.7</b>	<b>\$1,865.1</b>	<b>\$65.4</b>
<b>Real Estate and Rental and Leasing</b>	<b>\$3,143.7</b>	<b>\$106.2</b>	<b>\$3,080.8</b>	<b>\$104.1</b>
<b>Professional, Scientific, and Technical Services</b>	\$507.6	\$22.9	\$497.5	\$22.5
<b>Management of Companies and Enterprises</b>	\$1.9	\$0.1	\$1.8	\$0.1
<b>Administrative and Waste Services</b>	\$10.8	\$0.5	\$10.6	\$0.5
<b>Educational Services</b>	\$454.0	\$16.1	\$444.9	\$15.8
<b>Health Care and Social Assistance</b>	\$41.9	\$1.3	\$41.1	\$1.2
<b>Arts, Entertainment, and Recreation</b>	\$93.2	\$3.2	\$91.3	\$3.2
<b>Accommodation and Food Services</b>	\$17.7	\$0.5	\$17.3	\$0.5
<b>Other Services, except Public Administration</b>	\$0.7	\$0.0	\$0.7	\$0.0
<b>Total</b>	<b>\$11,133.5</b>	<b>\$352.8</b>	<b>\$10,910.8</b>	<b>\$345.8</b>
<b>Source: See Methodology Section</b>				

***The EVT's Impact on Fiscal Federalism***

Every state that levies their own income tax ties into the federal income tax code with automatic or legislative conformity as changes are made at the federal level. In this trying economic and budgetary climate, the EVT could filter down to the state level as states conform to the federal tax code in order to raise revenue. Or, on the other hand, some states may avoid conforming to the federal tax code in order

to avoid adopting the EVT—thus increasing the overall tax compliance costs on taxpayers. In either case, the EVT will have a negative impact on fiscal federalism as it leaves states with no good options when choosing whether or not to conform to the federal income tax code.

## Conclusion

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The implementation of a federal Enterprise Value Tax will extract around \$349 million from New Jersey's economy every year, capital that would be better used by New Jersey's partnerships to continue to expand their information, finance or real estate businesses crucial to an already anemic economy. Adoption of an EVT would also negatively impact fiscal federalism as it leaves state policymakers with no good options when choosing whether or not to conform to the federal income tax code.

Overall, New Jersey's state and local policymakers, as well as its Congressional delegation should oppose a federal EVT due to the economic damage it would inflict on New Jersey's businesses and citizens.

## Methodology

The model created to estimate the tax impact of the EVT draws primarily from data from the IRS, U.S. Department of Commerce's Bureau of Economic Analysis (BEA) and Bloomberg. The IRS data provides extensive details of partnerships by industry (NAICS) for calendar year 2009. This data was extrapolated to 2011 using the inflation forecast (GDP Price Index) from the Congressional Budget Office.

The total enterprise value based on "partners capital accounts" is \$9.4 trillion for 2011. The model conservatively assumes that businesses comprising half of this value (50 percent) would be subject to the EVT, or \$4.7 trillion. Given that the EVT would only apply when a partnership is sold, the model assumes an annual 2 percent turnover rate. Using price-book data from Bloomberg (using a ten-year average), the total taxable gain on sales (sale value minus enterprise value) would be \$94 billion each year.

New Jersey's share of taxable gain on sales was estimated based on New Jersey's share of Gross Domestic Product by industry. This data has been published by the BEA. New Jersey's estimated taxable gain on sales is \$2.3 billion for 2011.

The estimated increase in the capital gains tax liability under current law and the EVT was derived by multiplying the taxable gain on sales by the blended rate under the two scenarios and taking the difference.

The estimated tax impact of the EVT is dependent on the validity of the assumptions used in the model. As such, the tables "Appendix I" and "Appendix II" show the sensitivity of the tax impact estimates to changes in the assumptions. Appendix I shows that a one percentage point decrease in turnover (to 1 percent), yields a decrease in net tax increase of \$5.4 billion nationally or \$170 million in New Jersey.

Appendix I							
Tax Impact of the Enterprise Value Tax with 50 percent of Enterprise Value Impacted and 1 percent Turnover in Assets							
Calendar Year 2011 in Millions of Dollars							
Top Capital Gains Tax Rate (a)		Capital Gains Taxes Paid		Capital Gains Taxes Paid Under Enterprise Value Tax		Net Tax Increase	
		National	New Jersey	National	New Jersey	National	New Jersey
Current Law (Short-Term Holdings)	30.0%	\$5,567	\$176	\$11,133	\$353	\$5,567	\$176
With Expired Bush Tax Cuts and Medicare Investment Surtax	38.5%	\$8,833	\$280	\$14,288	\$453	\$5,455	\$173
(a) The 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.							
Source: See Methodology section.							

Appendix II shows that a one percentage point increase in turnover (to 3 percent), yields an increase in the tax impact of \$5.4 billion nationally or \$170 million in New Jersey.

Appendix II							
Tax Impact of the Enterprise Value Tax with 50 percent of Enterprise Value Impacted and 3 percent Turnover in Assets							
Calendar Year 2011 in Millions of Dollars							
Top Capital Gains Tax Rate (a)				Capital Gains Taxes Paid Under Enterprise Value Tax		Net Tax Increase	
		National	New Jersey	National	New Jersey	National	New Jersey
Current Law (Short-Term Holdings)	30.0%	\$16,700	\$529	\$33,400	\$1,058	\$16,700	\$529
With Expired Bush Tax Cuts and Medicare Investment Surtax	38.5%	\$26,498	\$840	\$42,864	\$1,358	\$16,366	\$519
(a) The 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.							

<sup>1</sup> U.S. Internal Revenue Service (IRS) business data and economic characteristics of partnerships can be found here: <http://www.irs.gov/taxstats/bustaxstats/article/0,,id=97127,00.html>

<sup>2</sup> IRS projections for partnership filings can be found here: <http://www.irs.gov/pub/irs-soi/d6149.pdf>

<sup>3</sup> <http://www.ustreas.gov/press/releases/hp489.htm> 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.”

<sup>4</sup> For more information on taxation of “carried interest”, see: Holtz-Eakin, Doug, “The Tax Treatment of Carried Interest,” American Action Forum, June 2010. <http://americanactionforum.org/files/TaxTreatmentCarriedInterest.pdf>

<sup>5</sup> [(25% x 15% capital gains rates) + (75% x 35% ordinary income tax rate)]

<sup>6</sup> 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. The Common Sense Institute of New Jersey [www.CSINJ.org](http://www.CSINJ.org)

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<sup>7</sup> [(25% times 23.8% capital gains rates) + (75% x 43.4% ordinary income tax rate)].

<sup>8</sup> The Medicare investment surtax applies a 3.8 percent tax rate on investment income over \$250,000 for a married filer or \$200,000 for single filer. The surtax was included as part of the recently enacted federal health care legislation



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