

# Taxation of Carried Interest

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## Taxation of Carried Interest

Congress has had a long-standing interest in the tax treatment of carried interest—a form of compensation often received by fund managers of alternative investment vehicles (e.g., private equity or hedge funds). This interest dates back to a series of hearings on the topic in 2007. Much of the concern over the tax treatment of carried interest has been about its fairness and economic efficiency, which may be of increased salience as investments in alternative investment vehicles have grown. As of the second quarter of 2019, private equity and hedge funds had roughly \$14.3 trillion in assets under management—an increase of nearly 40% over the past four years.

The current tax treatment of carried interest is the result of the intersection of several parts of the Internal Revenue Code (IRC)—relating to partnerships, capital gains, qualified dividends, and property transferred for services provided. The net result of these interactions is that carried interest is generally taxed as a capital gain or qualified dividend, often at a rate of 20%. This 20% rate for carried interest is the top rate applicable to long-term capital gains, which applies to carried interest if held for more than three years. (In general, long-term capital gains tax treatment requires assets to be held for one year.) By contrast, the top tax rate on ordinary income—for example, earned income—is 37% through the end of 2025, and 39.6% thereafter.

Arguments to change the tax treatment of carried interest are often based on the economic principles of efficiency and equity. Tax systems are generally deemed to be more efficient when they tax similar activities in a like manner. Under the current characterization of carried interest, general partners' performance fees are taxed less heavily than other forms of compensation, leading to distortions in employment, organizational form, and compensation decisions. It is also argued that the current treatment of carried interest violates the principles of both horizontal and vertical equity.

Perhaps as a result of these arguments, a number of legislative proposals have been introduced over the years. The proposals would, if enacted, tax all or some of carried interest as ordinary income or treat the granting of carried interest as a subsidized loan. The proposed Ending the Carried Interest Loophole Act (S. 1639) would treat the grant of carried interest to a general partner as a loan from the limited partners made at a preferred interest rate. The bill proposes interest rates above the applicable federal rate, setting the interest rate at the average five-year corporate bond interest rate plus 9 percentage points.

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Congress has long taken notice of the tax treatment of carried interest—a form of compensation often received by fund managers of alternative investment vehicles (e.g., private equity or hedge funds). This interest dates back to a series of hearings on the topic in 2007.<sup>1</sup> Much of the concern over the tax treatment of carried interest has been about its fairness and economic efficiency, which may be of increased salience as investments in alternative investment vehicles have grown. As of the second quarter of 2019, private equity and hedge funds had roughly \$14.3 trillion in assets under management—an increase of nearly 40% over the past four years.

This report begins by providing an overview of how investment funds are structured, their compensation structures, and their current tax treatment. The remainder of the report discusses concerns with the current tax treatment of carried interest and options to address these concerns.<sup>2</sup>

## Fund Structure and Compensation

Over the past several decades, private equity funds, venture capital funds, hedge funds, and similar alternative investment vehicles have attracted large amounts of capital investment from institutional investors, such as pension funds and educational and charitable institution endowments, as well as from wealthy individual investors.<sup>3</sup> These funds pursue a wide range of investment activities. For example, private equity funds generally acquire ownership stakes in other companies and seek to profit by improving operating results or through financial restructuring, whereas hedge funds follow multiple strategies, investing in any market where managers see profit opportunities.

### Fund Structure

Although private equity firms and hedge funds may differ in their investment strategies, their structures are similar (see **Figure 1**). Nearly all are organized as partnerships, which means their earnings are not taxed at the firm level, but rather passed through to each partner and reported on their individual income tax returns. Hence, most partnerships can be thought of as conduits of taxable income or loss and tax attributes (e.g., whether the income is treated as a capital gain or

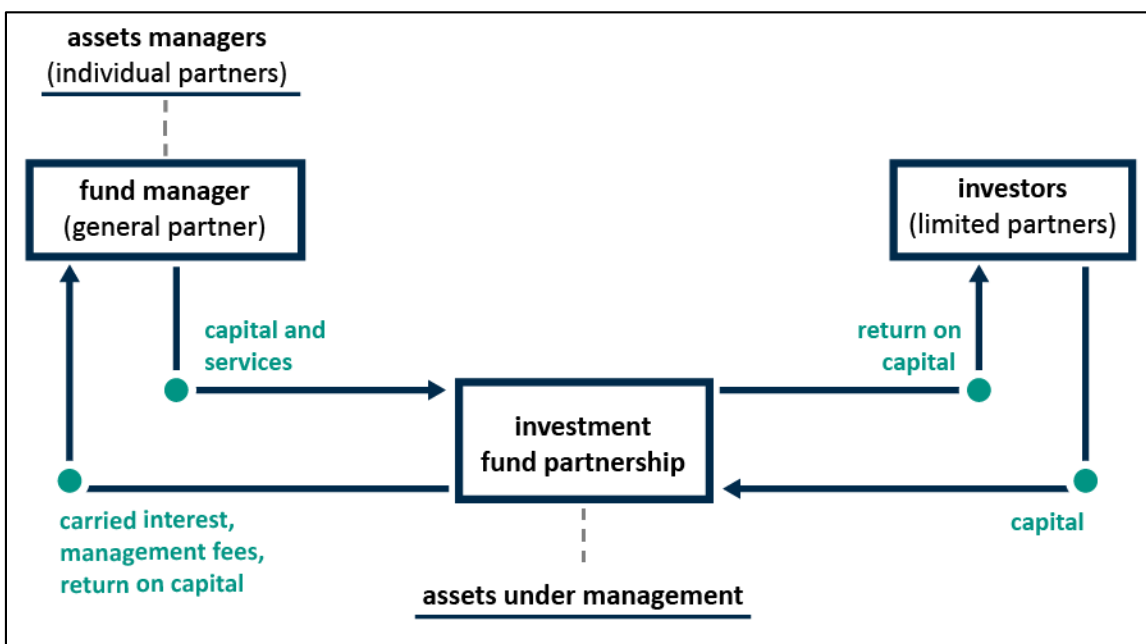
<sup>1</sup> Congressional hearings on carried interest in 2007 included the following: U.S. Congress, Senate Committee on Finance, *Carried Interest Part I*, 110<sup>th</sup> Cong., July 11, 2007, <https://www.finance.senate.gov/hearings/carried-interest-part-i>; U.S. Congress, Senate Committee on Finance, *Carried Interest, Part II*, 110<sup>th</sup> Cong., July 30, 2007, <https://www.finance.senate.gov/hearings/carried-interest-part-ii>; U.S. Congress, Senate Committee on Finance, *Carried Interest Part III: Pension Issues*, 110<sup>th</sup> Cong., September 6, 2007, <https://www.finance.senate.gov/hearings/carried-interest-part-iii-pension-issues>; and U.S. Congress, House Committee on Ways and Means, *Fair and Equitable Tax Policy for America's Working Families*, 110<sup>th</sup> Cong., September 6, 2007, <https://www.govinfo.gov/content/pkg/CHRG-110hhrg43307/pdf/CHRG-110hhrg43307.pdf>.

<sup>2</sup> This report does not attempt to address other tax issues related to investment funds. For further reading on this topic, see Gregg D. Polsky, “A Compendium of Private Equity Tax Games,” *Tax Notes*, February 2, 2015, pp. 615-625.

<sup>3</sup> Small public investors are generally not able to invest in hedge funds, because they lack either the assets or the income. Under U.S. law, the sale of shares, or interests, in an investment partnership constitutes an offering of securities, and must be registered with the SEC if the offering is public. To avoid registration and the associated disclosure requirements, most funds rely on exemptions in the securities laws that allow them to make unregulated “private” offerings. To qualify for these exemptions, prospective limited partners must meet various income and asset thresholds. (The most basic is the “accredited investor” standard—income of \$200,000 or more in the past two years and at least \$1 million in assets.) See <http://www.sec.gov/answers/accred.htm>.

ordinary income) to the individual partners.<sup>4</sup> They can, however, also be used to manipulate the allocation of tax attributes so as to shelter income and assets from taxation.

**Figure 1. Basic Private Investment Fund Structure**



**Source:** CRS adaptation of Joint Committee on Taxation.

There are two kinds of partners in investment funds (see **Figure 1**). The fund managers, who guide the investment strategy, are *general partners*.<sup>5</sup> Their background typically includes experience at a Wall Street investment bank. The general partners often invest their own capital in the funds, but this is usually a small share of the total capital managed by the fund.<sup>6</sup>

Outside investors, who contribute capital but have no say in investment or management decisions, are the *limited partners*. They are generally institutional investors—public and corporate pension funds, insurance companies, foundations, and endowments—or individual investors with significant financial resources. In contrast to the general partners, limited partners' contributions are usually a large share of the total capital managed by the fund.

Private funds<sup>7</sup>—a term which generally refers to private equity and hedge funds—typically establish multiple funds to accommodate the tax-planning preferences of different investors. Although these funds generally share a common pool of underlying assets, they are chartered in different jurisdictions to cater to different clientele. According to SEC data, more than one-third of the 32,537 registered private funds are registered in the Cayman Islands for tax purposes.<sup>8</sup>

<sup>4</sup> Examples of tax attributes that pass through to the individual partners include tax credits and net operating losses (NOLs).

<sup>5</sup> General partners are not required to contribute capital to form the partnership, although many contribute when the partnership is formed or subsequent to formation.

<sup>6</sup> According to media reports, general partners accounted for about 3% of funds raised by private equity firms in 2005. Dow Jones Private Equity Analyst, "Here's Where the Capital Came From In 2005," April 2006, p. 16.

<sup>7</sup> <https://www.sec.gov/divisions/investment/guidance/private-fund-adviser-resources.htm>

<sup>8</sup> Securities and Exchange Commission, *Private Fund Statistics*, First Calendar Quarter 2019, October 25, 2019,

Foreign investors and U.S. tax-exempt institutions may prefer to invest in foreign-chartered funds, whereas other types of U.S. investors find it disadvantageous to invest in foreign funds.<sup>9</sup>

A number of hedge funds and private equity partnerships have gone public by selling shares (or units) in an initial public offering (IPO). Their securities are now traded on the New York Stock Exchange and other major markets, and may be purchased by anyone. These firms, which include the Fortress Investment Group and Blackstone, operate much as before, but are required to file quarterly and annual financial statements and make the full range of disclosures required by the SEC.

## Types of Compensation

Fund managers, or general partners, typically receive two types of compensation for managing a fund.<sup>10</sup> In a common compensation agreement, general partners receive a management fee equal to 2% of the invested assets plus a 20% share in profits as carried interest. This has led to the compensation structure being referred to casually as “2 and 20.”<sup>11</sup> Whereas the management fee is generally fixed as a percentage of assets, the carried interest is variable because it is generally a share of fund profits once specified investment returns have been met (i.e., subject to a hurdle rate).

## Taxation of Carried Interest

The current tax treatment of carried interest is the result of the intersection of several parts of the Internal Revenue Code (IRC)—relating to partnerships, capital gains, qualified dividends, and property transferred for services provided.<sup>12</sup> The net result of these interactions is that carried interest is generally taxed as a capital gain or qualified dividend, often at a rate of 20%. This 20% rate is the top rate applicable to long-term capital gains, which are held for more than a year. (The tax rates on qualified dividends are the same as the tax rates applicable to long-term capital gains.) By contrast, the top tax rate on ordinary income—for example, earned income—is 37% through the end of 2025, and 39.6% thereafter.

The 2017 tax revision (P.L. 115-97) lengthened—from one year to three years—the period for which an investment fund is required to hold assets for the carried interest to be taxed as a long-term capital gain at a rate of 20%.<sup>13</sup> This change theoretically limited the preferential tax

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<https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2019-q1.pdf>.

<sup>9</sup> For example, foreign investors may prefer to invest in non-U.S. funds to avoid creating a U.S. tax presence or paying U.S. tax on the fund's earnings, while tax-exempt institutions may prefer non-U.S. funds (relative to other U.S. investors) because they do not pay taxes on repatriated earnings.

<sup>10</sup> Limited partners receive their profits as interests that are generally taxed as capital gains.

<sup>11</sup> This terminology for hedge fund compensation is generally attributed to Victor Fleischer, “Two and Twenty: Taxing Partnership Profits in Private Equity Funds,” *New York University Law Review*, 2008. The actual mix of compensation is set in the individual partnership agreements. See Ingo Stoff and Reiner Braun, “The Evolution of Private Equity Fund Terms Beyond 2 and 20,” *Journal of Applied Corporate Finance*, vol. 26, no. 1 (Winter 2014), for discussion of this evolution.

<sup>12</sup> A full description of these interactions can be found in U.S. Congress, Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests*, committee print, 110<sup>th</sup> Cong., July 10, 2007, JCX-41-07.

<sup>13</sup> Carried interest held less than three years is taxed as ordinary income at a maximum rate of 37%.

treatment of carried interest—though the actual effect is uncertain given that funds customarily employ five- to seven-year holding periods.<sup>14</sup>

Although capital gains income is included when calculating the net investment income tax (NIIT), carried interest received by fund managers is likely exempt. The NIIT is an additional 3.8% tax on certain net investment income when a taxpayer's income is above statutory thresholds.<sup>15</sup> The NIIT does not apply to active partnership income, which would likely exempt carried interest received by fund managers.<sup>16</sup>

## Policy Proposals for the Taxation of Carried Interest<sup>17</sup>

Arguments to retain the current tax treatment of carried interest often center on how increasing taxes on general partners' compensation would reduce their incentive to start investment funds. That reduced incentive, in turn, could diminish innovation and possibly make private equity markets—and consequently businesses—less efficient. It is unclear to what extent the current treatment of carried interest promotes innovation and market efficiency.

Arguments to change the tax treatment of carried interest are often based on the economic principles of efficiency and equity. Tax systems are generally deemed to be more efficient when they tax similar activities in a like manner. Critics note that under the current characterization of carried interest, general partners' performance fees are taxed less heavily than other forms of compensation, leading to distortions in employment, organizational form, and compensation decisions.<sup>18</sup> As a result of these distortions, critics maintain that the economy misallocates its scarce resources. This misallocation could result in investment funds choosing riskier investments in an effort to exceed the hurdle rates required for the granting of carried interest.

Critics also argue that the current treatment of carried interest violates the principles of both horizontal and vertical equity. Horizontal equity holds that individuals with the same income should owe the same in taxes regardless of the income's form. Vertical equity holds that individuals who earn more should pay more in taxes than those who earn less. The following sections discuss various proposals regarding the taxation of carried interest.

### Maintain the Current Tax Treatment of Carried Interest

Policymakers may choose to maintain the current tax treatment of carried interest, effectively taxing it as a long-term capital gain in most cases. This option reflects a view that the current tax treatment of carried interest strikes an appropriate policy balance. According to the chief executive officer of the American Investment Council, an industry advocacy group, raising taxes

<sup>14</sup> Adrian M. Schrock, David H. Benz, and Sal (Kislay) Shah, "TCJA Renews Focus on Carried Interest Models for Private Equity Funds," Crowe LLP, July 24, 2018, <https://www.crowe.com/insights/tcja-renews-focus-on-carried-interest-models-for-private-equity-funds>.

<sup>15</sup> Income above \$200,000 (\$250,000) is subject to this tax for single (married) tax filers.

<sup>16</sup> Donald Marron, *Goldilocks Meets Private Equity: Taxing Carried Interest Just Right*, Tax Policy Center, October 6, 2016, p. 15.

<sup>17</sup> This section does not attempt to provide a comprehensive list of all policy options, but instead covers the range that has been actively debated over the past decade.

<sup>18</sup> Aviva Aron-Dine, *An Analysis of the "Carried Interest" Controversy*, Center on Budget and Policy Priorities, August 1, 2007.

on carried interest would discourage entrepreneurship and investment.<sup>19</sup> Others assert that increasing the taxation of carried interest would result in a reduction in the rate of return to investors—including pension funds and other institutional investors. In addition, some have argued that the issue is more nuanced than it initially appears and that an economically optimal treatment is not possible.<sup>20</sup>

## Taxation of Carried Interest as Ordinary Income

Policymakers may choose to change the current tax treatment of carried interest and tax it like ordinary income (e.g., salaries, wages). Multiple commentators over the past decade have suggested that carried interest is the return to the general partner's labor effort and should therefore be taxed as labor income (including being subject to payroll taxes).<sup>21</sup> In the 116<sup>th</sup> Congress, the Carried Interest Fairness Act (S. 781 and H.R. 1735) has proposed this change. According to the Congressional Budget Office, this option would raise \$14 billion in tax revenues over the 2019-2028 budget window.<sup>22</sup>

This option's proponents argue that the general partner is being compensated for providing the labor to generate a positive return on investment for the fund—similar to how other workers provide their services to their employers. From this view, the current-law tax treatment of carried interest violates the principle of horizontal equity because carried interest income is taxed differently than other forms of labor income.<sup>23</sup> This violation of horizontal equity holds as long as carried interest is analogous to either wages or performance-based compensation (e.g., a bonus).

Opponents have criticized these proposals, asserting that they have the potential to tax carried interest too heavily. For example, one researcher argued that recharacterizing carried interest as ordinary income would result in excessive taxation without other reforms.<sup>24</sup> Opponents also raised concerns that increased taxation would encourage general partners to direct investment to riskier options. Why this would occur is unclear, as a change in tax rates faced by fund managers would apply to the disposition of assets and not the choice of which assets to hold.<sup>25</sup>

Some commentators have also argued that taxing all carried interest as ordinary income would not be appropriate based on the view that a portion of carried interest is a return on the investment

<sup>19</sup> Naomi Jagoda, "Top Finance Democrat offers bill to end tax 'loophole' Trump pledged to eliminate," *The Hill*, May 23, 2019.

<sup>20</sup> Alan Viard, "The Taxation of Carried Interest: Understanding the Issues," *National Tax Issue*, vol. 61, no. 3 (September 2008), pp. 445-460.

<sup>21</sup> See Steven M. Rosenthal, *Taxing Private Equity Funds as Corporate "Developers,"* Urban Institute, January 28, 2013, <https://www.urban.org/research/publication/taxing-private-equity-funds-corporate-developers> and "Monsters, Inc?" *The Economist*, January 28, 2012, as examples of this view.

<sup>22</sup> Sen. Baldwin and Rep. Pascrell have pointed to the Congressional Budget Office, *Options for Reducing the Deficit: 2019 to 2028*, December 13, 2018 (<https://www.cbo.gov/publication/54667>), as an estimate of their legislative proposal's revenue-raising potential.

<sup>23</sup> The principle of horizontal equity is based on the idea that taxpayers with equal income should pay equal taxes. A second application of this principle to carried interest is that all income earned from the provision of labor should be taxed the same.

<sup>24</sup> Donald Marron, *Goldilocks Meets Private Equity: Taxing Carried Interest Just Right*, Urban-Brookings Tax Policy Center, October 7, 2016. To the extent that the fund's limited partners are tax-exempt or foreign persons not subject to U.S. tax, the issue of double taxation is irrelevant. The argument presented was based on the fact that management fees were then deductible against ordinary income. The 2017 tax revision eliminated the deductibility of investment expenses. In addition, the author's preferred policy option would facilitate tax arbitrage opportunities where expenses could offset income taxed as ordinary income instead of being realized as income taxed as capital gains.

<sup>25</sup> Theoretically, higher tax rates can actually encourage risk-taking by reducing variance in the return to risk—if full loss offsets are available.



of human capital from the general partners. The general partners' sweat equity—or “enterprise value”—is more broadly used to describe the portion of a fund's increased value that can be attributed to the fund's good track record or valued brand (i.e., goodwill). In this view, the fund manager is analogous to a business owner contributing labor to a business—and should face capital gains taxes upon the sale of the business. This analogy may hold for investment funds listed and sold on public stock exchanges. However, it appears to break down when applied to income derived from fund operations because profits from business operations are generally treated as ordinary income.

## Taxation of a Portion of Carried Interest as Ordinary Income

Policymakers may choose to tax part of carried interest as ordinary income and part as a long-term capital gain. Perhaps as a result of general concerns about the potential to tax carried interest too heavily, several policy proposals have called for taxing a portion of carried interest as ordinary income. In the 111<sup>th</sup> Congress, a House-passed amendment to the American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213) would have treated a portion of carried interest as ordinary income. Alternatively, the CUT Loopholes Act (S. 268 in the 113<sup>th</sup> Congress) would have addressed concerns about the “enterprise value” portion of carried interest by taxing the goodwill component of carried interest as a capital gain, but the remaining carried interest as ordinary income. However, valuing the components of carried interest is not straightforward because the return on intangible assets, such as enterprise value, is difficult to directly determine. In addition to partially addressing economic equity concerns, these proposals generally would have taxed carried interest income only when it was realized (through the selling of fund assets). Thus, these bills did not address deferral, whereby taxpayers can choose to delay recognition of income to future years.

## Taxation of Carried Interest as a Loan

As an alternative to resolve the valuation difficulties, two legislative proposals would treat the grant of carried interest to the general partner as a loan from the limited partners made at a preferred interest rate.<sup>26</sup> Senate Finance Committee Ranking Member Ron Wyden (in the Ending the Carried Interest Loophole Act, S. 1639, 116<sup>th</sup> Congress) and former House Ways and Means Committee Chairman Dave Camp (in the Tax Reform Act of 2014, H.R. 1, 113<sup>th</sup> Congress) each introduced legislation that would treat carried interest in this manner, though the proposals differ along a number of dimensions.<sup>27</sup> The proposals would generally tax fund managers currently at ordinary income tax rates on the difference between an “adequate” amount of interest on the loan and the amount of interest paid to limited partners as interest from the fund managers. Any gains fund managers received from subsequently selling the share in the fund that represent carried interest would then be taxed at capital gains tax rates.

Determining the reference rate needed to set the “adequate” amount of interest requires an element of judgement. Internal Revenue Code Section 7872 uses the applicable federal rate (as determined by interest rates on U.S. treasury debt) as a reference for a below-market loan. This rate is generally considered the risk-free rate of return and may not be appropriate to apply to

<sup>26</sup> This treatment is analogous to the cost-of-capital approach discussed in Victor Fleischer, “Two and Twenty: Taxing Partnership Profits in Private Equity Funds,” *New York University Law Review*, 2008.

<sup>27</sup> One of the notable differences is that the Tax Reform Act of 2014 would have exempted real estate partnerships from this change in tax treatment.

carried interest, given the risky nature of fund investments.<sup>28</sup> Both the Ending Carried Interest Loophole Act and the Tax Reform Act of 2014 proposed interest rates above the applicable federal rate.<sup>29</sup>

## Additional Policy Concerns

In addition to the issues identified above, discussions have occurred on several other issues related to carried interest.

### The Use of Offshore Entities

Investment funds may adopt more complex structures than the basic example provided in **Figure 1**. A structure may include a foreign corporation inserted between the investment fund and certain types of investors—typically the fund’s foreign and tax-exempt investors—to address specific concerns with U.S. taxes and U.S.-based fund managers. These “blocker corporations” are generally incorporated in low-tax or zero-tax foreign jurisdictions.

U.S. tax-exempt investors (e.g., pension funds or university endowments) may prefer the use of blocker corporations to shield the tax-exempt investor from the unrelated business income tax (UBIT). UBIT income is generally income earned by tax-exempt organizations on activity not connected to their exempt purpose.<sup>30</sup> In the absence of a blocker corporation, the investment income financed by debt would generally be taxed at the 21% corporate tax rate.

This structure is also generally beneficial for foreign investors (such as sovereign wealth funds), because it can reduce the likelihood that they are subject to U.S. tax or reporting requirements. The use of a blocker corporation does not generally result in a reduction of total U.S. tax liability for foreign investors.<sup>31</sup>

These more complex structures that include foreign blocker corporations provide a tax deferral opportunity not generally available to an entirely U.S.-based fund structure. This deferral opportunity can arise if the carried interest in the foreign corporation is structured as a contractual right instead of the generally used profits interest that is subject to forfeit. Further, the value of the carried interest can compound over time, increasing the benefits of deferral. Then-House Committee on Ways and Means Chairman Rangel introduced several bills in the 110<sup>th</sup> Congress (H.R. 3996, H.R. 4351, and H.R. 6049) that would have included compensation deferred through foreign corporations as income to the fund manager in the year earned.

<sup>28</sup> U.S. Congress, Joint Committee on Taxation, *Present Law and Analysis Related to the Tax Treatment of Partnership Carried Interests and Related Issues, Part 1*, committee print, 110<sup>th</sup> Cong., and U.S. Congress, Joint Committee on Taxation, *Present Law and Analysis Related to the Tax Treatment of Partnership Carried Interests and Related Issues, Part 2*, committee print, 110<sup>th</sup> Cong., September 4, 2007, JCX-63-07.

<sup>29</sup> The Ending Carried Interest Loophole Act would set the interest rate at the average five-year corporate bond interest rate plus 9 percentage points, while the Tax Reform Act of 2014 would have set the interest rate at the federal long-term interest rate plus 10 percentage points.

<sup>30</sup> See CRS Report R45922, *Tax Issues Relating to Charitable Contributions and Organizations*, by Jane G. Gravelle, Donald J. Marples, and Molly F. Sherlock; and CRS Report R44293, *College and University Endowments: Overview and Tax Policy Options*, by Molly F. Sherlock et al.

<sup>31</sup> Deferred compensation arrangements are significantly less common in U.S.-chartered funds because they result in investors losing the deduction associated with compensation and facing higher tax liabilities.

## Payroll Taxes

Although it is not directly linked to the taxation of carried interest, capital gains income is not subject to payroll taxes.<sup>32</sup> If carried interest (or a part of it) were treated as earned income, then the income would be subject to payroll taxes. This would be most relevant to the 2.9% Medicare Hospital Insurance tax, which is not subject to an income cap.<sup>33</sup> In addition, recharacterized income could also be subject to the 0.9% Medicare tax that applies to (earned) income over statutory thresholds.<sup>34</sup> A number of the proposals mentioned above would have subjected carried interest to these payroll taxes.

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<sup>32</sup> See CRS Report R40425, *Medicare Primer*, coordinated by Patricia A. Davis for more detail on Medicare finance.

<sup>33</sup> In contrast, Social Security payroll taxes apply to a maximum of \$137,700 in earnings in 2020. This cap is adjusted annually for inflation.

<sup>34</sup> Income above \$200,000 (\$250,000) is subject to this tax for single (married) tax filers.