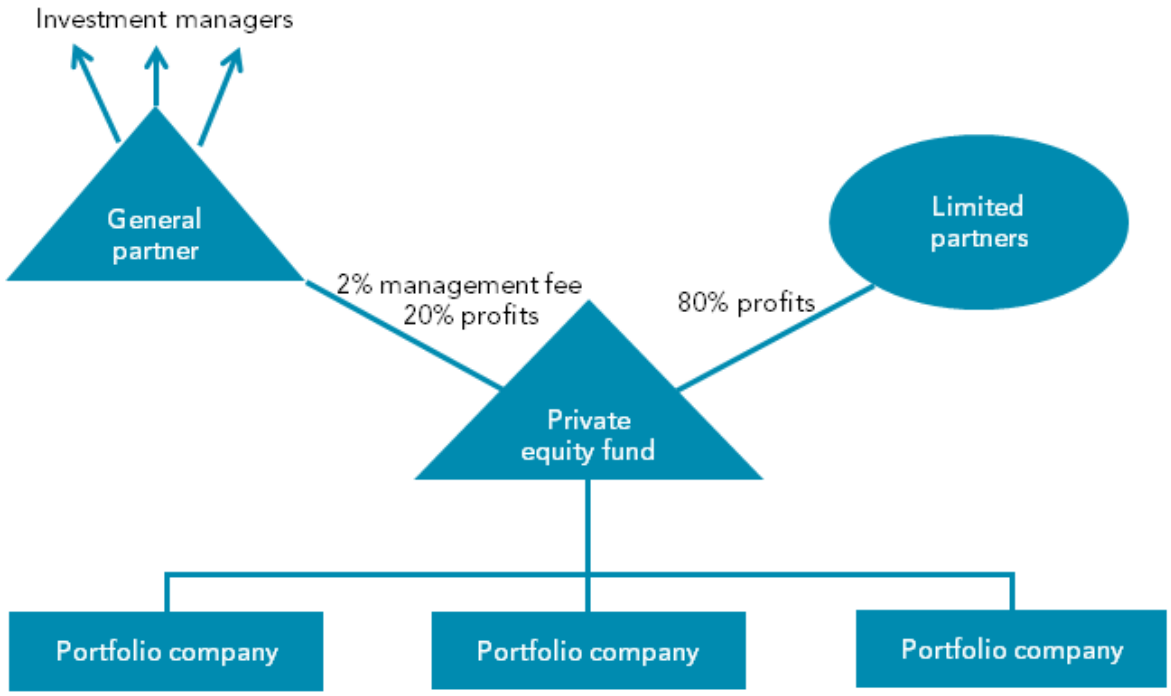
What is carried interest, and should it be taxed as capital gain?

Carried interest, income flowing to the general partner of a private investment fund, is generally treated as capital gains for the purposes of taxation. This tax preference is viewed as an unfair, market-distorting loophole by some but consistent with the tax treatment of other entrepreneurial income by others.

Carried interest is a contractual right that entitles the general partner of a private investment fund (often a private equity fund) to share in the fund's profits (figure 1). A fund typically uses the carried interest to pass through its net capital gains to the general partner which, in turn, passes the gains on to the investment managers. The managers pay a federal personal income tax on these gains at a rate of 23.8 percent (20 percent tax on net capital gains plus 3.8 percent investment tax).

FIGURE 1

A Typical Private Equity Fund



The general partner receives its carried interest principally in exchange for its commitment to providing investment management services to the fund. (Typically, the general partner also receives a separate annual fee based on the size of the fund's assets.) The limited partners receive the balance of the fund's profits in exchange for

providing predominantly all of the fund's capital. A typical division for a private equity fund is 20 percent of the profits to the general partner and 80 percent to the limited partners.

Private equity funds managed $3.8 trillion in 2014, a massive increase over the $100 billion managed in 1994. They use their capital to buy companies and improve the operations, governance, capital structure, and strategic positions of the companies. Then they sell the companies and pass any profits to the general and limited partners.

Many commentators argue that it would be fairer and more efficient economically for carried interest to be taxed like wage and salary income, which is subject to a top rate of 43.4 percent (39.6 percent plus 3.8 percent). They draw an analogy between the general partners and investment bankers, who pay tax at ordinary rates on their wages, salaries, and bonuses. They also object that most service providers are not able to treat their income as capital gains.

But others believe that the general partners are more like entrepreneurs who start a new business and may, under current law, treat part of their return as capital— not as wage and salary income—for their contribution of "sweat equity." Our tax system largely accommodates this conversion of labor income to capital because it cannot measure and time the contribution of the "sweat equity."

Still others defend the current tax treatment of carried interest as a way to mitigate the unfair double taxation of corporate income. Currently, income earned within a partnership is subject only to the individual income tax, whereas income earned within a C corporation is subject to the corporate tax when earned and the individual income tax when realized or distributed.

FURTHER READING

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