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Goldilocks Meets Private Equity: Taxing Carried Interest Just Right

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ABSTRACT

Controversy rages about how to tax carried interest—the profit shares received by managers of buyout funds, venture capital funds, and angel syndicates. Managers currently pay capital income taxes at effective rates of up to 25 percent on any long-term capital gains and qualified dividends they receive as carried interest. Many reformers believe this income—some received by exceptionally wealthy fund managers—is labor compensation and should be taxed at rates of up to 44 percent. Defenders of current practice argue that carried interest is capital income just like other returns from investing in business ventures, taking financial risk, and putting in sweat equity. I demonstrate that these two views—and a third that sees carried interest as a tax arbitrage between managers and tax-exempt investors—can be reconciled by reforming how both managers and investors are taxed. Current practice taxes carried interest too little. Treating it as labor income without other reforms would tax it too much when investors are taxable individuals. To tax carried interest just right, it should be labor income for managers and deductible against ordinary income for investors. This approach directs the favorable tax treatment of capital income entirely to the investors who provide capital and bear financial risk, rather than allowing some preference to be transferred to managers. This approach taxes carried interest as labor income yet protects the usual tax benefits for capital gains and dividends. One way to implement this approach is to treat funds as businesses and allow investors to deduct carried interest as a business expense.

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INTRODUCTION

Partnerships in myriad industries, from restaurants to oil and gas exploration, reward managers with a share of their profits. Those profit shares are often known as carried interest (or carry), harkening back to the days when ship captains shared in the gains from selling cargo they carried for merchants to distant ports. Carried interest encouraged those captains to deliver profits for the merchants backing their voyages. Today, carried interests do the same for partnership managers.

Practitioners and analysts have long noted that the allocation of profit shares poses important tax policy questions.[1] Public concern about carried interest did not take off, however, until the rise of private equity firms, partnerships that buy ownership stakes in private companies, usually organized as C corporations.

Over the past decade, controversy has raged about how to tax the carried interests of managers of buyout funds, venture capital funds, angel syndicates, and other private equity funds. Those carried interests, which often amount to 20 percent of a fund's profits, are currently treated as capital income, with long-term capital gains and qualified dividends facing effective federal tax rates up to 25 percent. Many observers believe, however, that carried interest should be taxed as labor income with rates up to 44 percent.

This debate has crystalized into three seemingly conflicting perspectives:

- The ***labor services*** view sees carried interest as a way investors compensate fund managers for coordinating partnerships, finding and structuring investment opportunities, advising portfolio companies, and arranging favorable exits. Carried interest is thus compensation for providing services and should be taxed as labor income, like any payment for services. This is especially important, many believe, because some fund managers are exceptionally wealthy and should not pay lower tax rates on their compensation than do regular wage and salary workers.[2]

[1] Sanchirico (2008) provides references to key articles. The granting of profits interests in many businesses organized as partnerships raises a fundamental question about the carried interest debate: why should we treat the carried interest of fund managers differently from profits interests received by entrepreneurs in other businesses? Weisbach (2008) develops this argument in detail and argues that the similarities among profit interests imply that carried interest should not be taxed as labor income. Other analysts have gone to the other extreme, suggesting that all profits interests be taxed as labor income (Gergen 1992). These are important arguments. However, the carried interest of fund managers does differ from other profit interests in two material ways. First, as discussed below, carried interest facilitates a tax arbitrage with tax-exempt investors that does not exist in other sorts of businesses. Second, carried interest is often received by fund managers who are exceptionally wealthy, sparking more public concern than for profit interests more generally.

[2] Fleischer (2008) articulated this view, igniting the ongoing policy debate. Many observers have since adopted this perspective, including President Obama (US Department of the Treasury 2016).

- The ***entrepreneurship*** view sees carried interest as the reward managers get for developing new ventures, improving existing businesses, and creating business value. Carried interest should therefore be taxed as capital income, just like the returns of entrepreneurs and angel investors who take the risk of investing financial capital and sweat equity in their companies.[3]

- The ***joint tax*** view sees carried interest as creating a tax arbitrage in which tax-exempt investors who get no tax benefit from capital gains can transfer those gains to managers who do benefit. The joint tax approach focuses on how an entire transaction is taxed, including all participants. From that combined perspective, carried interest is taxed appropriately overall for funds backed by individual investors. This is because managers' tax benefits from the capital gains preference are offset by investors' tax costs when they transfer that preference. Carried interest is undertaxed, however, when investors are tax-exempt institutions, since they bear no offsetting tax costs.[4]

In this paper, I demonstrate that these three disparate views can be reconciled into a single, coherent approach to taxing carried interest.[5] Current practice taxes carried interest too little, as both the labor services and joint tax views emphasize. Taxing carried interest as labor income eliminates that problem.[6] If that is the only reform, however, carried interest will be taxed too much when it comes from a one group of investors: taxable individuals. Individuals account for a small portion of fund investments, so this overtaxation is small relative to today's undertaxation.[7] But our goal should be to tax carried interest just right. And this overtaxation can be large for specific types of funds, such as angel syndicates, that focus on individual investors. To tax carry just right, individual investors should get a full tax deduction for the carried interest they pay fund managers. Carried interest should thus be labor income for managers and deductible against ordinary income for individual investors.

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[3] The private equity trade association, the American Investment Council, articulates this view, as do some fund managers ("Carried Interest," American Investment Council, September 30, 2015, http://www.investmentcouncil.org/news-and-policy/articles/carried-interest/). Weisbach (2008) offers related arguments, emphasizing the similarities between fund managers and entrepreneurs.

[4] Sanchirico (2008) articulated this view, emphasizing the need to consider taxes on investors, not just fund managers. As he notes, arbitrage is also a concern for corporations, since they pay the same taxes on capital gains as on other income, as it is for some other types of investors. Knoll (2008) used this view in estimating net revenue from changing how carried interest is taxed, and Viard (2008) used it to evaluate the economics of taxing carried interest.

[5] Rosenthal (2013a, 2013b) recently introduced a fourth perspective, the developer theory, under which many private equity funds have all their income taxed as business income rather than capital income. The developer theory focuses on all fund income, not carried interest specifically. The logic of my analysis implies the developer view significantly overtaxes private investment funds relative to other ways of structuring investments.

[6] Taxing carried interest as labor income actually solves two problems: the undertaxation of carried interest caused by its treatment as capital gains and a less well-known loophole, discussed later, that allows some carried interest from funds treated as businesses to avoid both self-employment taxes and the net investment income tax.

[7] Prequin reported, for example, that North American foundations, endowments, pension funds, and insurance companies accounted for about 75 percent of investors in buyout funds, with family offices and wealth managers accounting for 11 percent. The difference in terms of invested dollars is likely larger, given the large size of institutional investors. [Joseph Borda, "North America–Based Private Equity Investors' Appetite for Buyout Funds—January 2015," *Prequin* (blog), January 14, 2015, https://www.preqin.com/blog/0/10592/private-equity-buyout-funds].

This approach taxes carried interest as labor income, consistent with the labor services view. It eliminates the tax arbitrage identified by the joint tax view. And it achieves the primary goal of the entrepreneurship view: preserving the lower tax rates on capital gains and dividends that apply when people invest in businesses. Those lower rates apply when people invest in corporations directly, whether as founders, angels, or public shareholders, and should be equally available when they invest through partnerships. My approach differs from current practice, however, by directing all those tax benefits to fund investors. That makes sense because it is the funds, not the managers as individuals, who invest in businesses, bear financial risk, and provide any sweat equity. Managers can still benefit from the lower tax rates on capital income, but only to the extent that they invest in their funds.

Goldilocks can thus eat her porridge and have it too: carried interest that is taxed as labor income while maintaining the usual tax preferences for capital gains and dividends resulting from investment and sweat equity. Some critics of current practice object to these features of the tax system, believing that returns to sweat equity should be taxed as ordinary income or that all capital gains should be taxed as ordinary income. These views deserve serious debate but stretch far beyond the issues involving carried interest. My analysis thus takes those features as given, and asks how we should tax carried interest within the logic of our current system. The answer is that carried interest should be taxed as labor income to managers and deductible against ordinary income for investors.

That approach reflects a basic principle of taxing income: if a person spends resources to generate income, those resources should be deductible. Putting that principle into practice, however, poses some complications. First, we need to disaggregate net fund returns into two parts: the gross returns before carry is allocated to managers and the carry itself. The gross returns are taxed as capital income to investors, while the carry is labor income to managers and a deductible expense for investors.

Second, we need to decide how investors get their deductions. If funds are viewed as a type of investor—as they generally are today—individual investors should deduct carried interest against their ordinary incomes, just as they already do with the cash management fees they pay. But such deductions are subject to several limits that greatly reduce their value for many investors. If funds are viewed as a type of business, as some scholars and court cases have recently suggested,[8] individual investors should deduct carried interest as a passive business expense. Those deductions face some limits, but to a lesser extent than do investment expenses. Treating carried interest as a business expense appears to be the most favorable approach available to investors given other features of our tax system, so long as their fund incomes continue to be treated as capital income and they can make use of the resulting tax deductions.

[8] Sanchirico (2008) notes that funds may by treated as a trade or business if carried interest is taxed as labor income. Rosenthal (2013a) argues that funds should be treated as a trade or business, and Rosenthal (2013b) elaborates and discusses the *Sun Capital* ERISA case in which a court agreed.

The rest of the paper develops this analysis as follows: The next section describes how funds operate and how returns are allocated among managers and investors. The third section examines three broad approaches to taxing carried interest: current practice, partial reform that recharacterizes carried interest as labor income, and full reform that treats carry as labor income and as deductible against ordinary income. The fourth section documents the many benefits of full reform. The fifth section examines whether taxing carried interest as labor income may discourage investment. The sixth section discusses various approaches to giving investors credit for the carried interest they pay; I note that the most favorable approach for investors is treating funds as businesses that generate capital income and separating carried interest so investors can deduct it against their ordinary incomes. The final section then concludes.

BUYOUT FUNDS, VENTURE CAPITAL FUNDS, AND ANGEL SYNDICATES

The investment funds at the center of the carried interest controversy are known as *private equity funds* because they own equity in private companies. That term is also used more narrowly to refer to **buyout funds**, which typically purchase entire companies or acquire corporate divisions and establish them as stand-alone companies. **Venture capital funds** typically invest in young, often rapidly growing companies. **Angel syndicates** are a less famous structure in which individual investors pool money to invest in venture deals identified by a lead angel investor. Angel syndicates are tiny compared to traditional buyout and venture funds. They are an important case to consider, however, because of widespread interest in expanding access to venture investing. Syndicates also provide a test case for focusing on the tax issues raised by carried interest separately from other issues that swirl around private equity, such as the exceptional wealth of the most successful fund managers.

Although I focus on private equity in this paper, taxing carried interest is an issue for any investment funds that compensate managers with long-term capital gains and qualified dividends. Hedge funds invest in publicly traded stocks, bonds, commodities, currencies, financial derivatives, and other assets. In many cases, these funds realize only short-term capital gains or are not structured to pass long-term gains through to their managers and those do not raise the same issues about taxing their carry.[9] But some hedge funds do compensate managers with long-term capital gains and thus pose the same issues discussed here. The same is true for any real estate, oil and gas, or other partnerships that compensate managers with long-term capital gains.

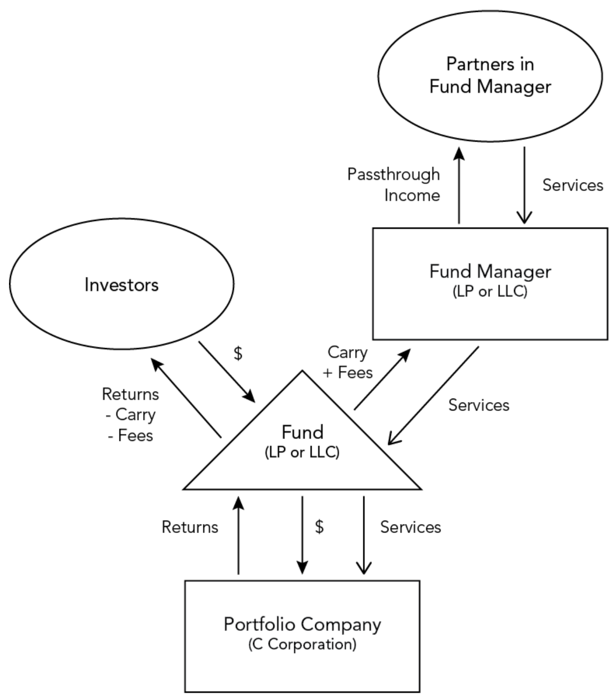
Buyout funds, venture funds, and angel syndicates—which I will generally refer to as *funds*—differ in many respects. However, they compensate their managers in similar ways, with a combination of cash management fees and a carried interest in fund profits. For buyout and venture funds, a canonical structure is the famous two-and-twenty: an annual management fee

[9] Victor Fleischer, "Why Hedge Funds Don't Worry about Carried Interest Tax Rules," *New York Times*, May 14, 2014.

of 2 percent of committed capital and a carried interest of 20 percent of profits.[10] Angel syndicates may forgo the management fee and have only carried interest, often shared with an intermediary who helps the lead angel find investors. A typical syndicate deal might have a 5 percent carry for the intermediary and 15 percent for the angel lead.[11]

Figure 1 illustrates the primary money and service flows for a private investment fund. Investors contribute capital to the fund and receive returns on the fund's investments, less carried interest allocated to and fees paid to the fund manager.[12] The fund, in turn, invests capital in one or more portfolio companies (for simplicity, the figure has just one), provides management advice and other services, and receives returns from eventually selling its ownership stake and, possibly, from dividends along the way. The fund manager receives fees and carry from the fund and provides it services, some of which directly benefit the fund and some of which indirectly benefit the fund by improving its portfolio companies. The fund manager is owned by one or more partners, who provide the fund manager services and receive income in return.

FIGURE 1
The Flow of Money and Services in a Private Investment Fund



[10] In practice, fund terms can differ significantly, both in their level and the way they are calculated. For example, profits might have to exceed a specified rate of return before managers qualify for their carried interest, and management fees may scale down after several years or when the general partner raises a new fund. Buyout funds may receive fees from portfolio companies; these are usually offset, in whole or in part, by reductions in fund management fees. Buyout and venture funds typically base carry on fund performance, while angel syndicates typically base it on the performance of individual deals. Funds may also have some expenses that are charged to the fund and its investors, rather than paid to the fund managers. My analysis extends to those variations without changing the basic conclusions.
[11] These figures are based on information published by a large intermediary for angel syndicates ("Economics of Syndicates," AngelList, May 2015, https://angel.co/economics-syndicates).
[12] Funds are typically structured as partnerships, with investors as the limited partners and the fund manager as the general partner.

This figure illustrates five crucial points for understanding how carried interest relates to the flow of services, compensation, and entrepreneurial effort.

- Although portfolio companies and their fund managers may be structured differently, they share one important feature: they are operating businesses. The fund manager provides services to the fund, and the portfolio companies sell (or, for early-stage companies, aspire to sell) products and services to customers. To highlight that similarity, both are represented as rectangles.[13]

- Managers are entrepreneurs when they found and build their fund management businesses, just as the founders of portfolio companies are. If fund managers ever have the opportunity to sell their businesses, they should receive the same capital income tax treatment as other entrepreneurs selling similarly structured service businesses. (This is a feature of being a rectangle.)

- The fund is a different kind of entity. Under current practice, it is often treated as an investor, not a business. That distinction has been questioned in recent court cases and scholarly articles.[14] But even if the fund were deemed a business, its character may differ from the portfolio companies and the fund manager. For that reason, it is represented by a triangle. A central issue in taxing private investment funds is identifying whether and how a fund differs from operating businesses or, abstractly, whether and how a triangle differs from a rectangle.

- Carried interest appears in two places: as income to managers and as a cost to investors. Policy debate overwhelmingly focuses on the manager side of this relationship. This is understandable given some prominent fund managers' exceptional wealth and income. But thoughtful tax policy should also ensure that carried interest is treated appropriately from investors' perspective.

- Portfolio companies get capital and services from the fund, not from the managers individually. This simple observation helps resolve the debate about carried interest and entrepreneurship. Defenders of current practice often argue that fund managers put sweat equity into portfolio companies and bear financial risk, and thus deserve capital income tax treatment on their carry. In reality, it is the funds that bear the financial costs and risks of putting capital and sweat equity into portfolio companies, with managers acting as their agents. To treat capital gains and sweat equity fairly requires that the fund as a whole get appropriate capital income tax treatment. That does not mean that

[13] To emphasize the similarities of the fund manager and the portfolio companies and their difference from the fund, the shapes in Figure 1 differ somewhat from those used in some legal conventions. For example, I use a rectangle to denote an entity that is an operating business, regardless of form, while a common convention elsewhere is to use rectangles solely for C corporations.
[14] Rosenthal (2013a, 2013b).

managers need to get capital income tax treatment on their carry. Returns to capital gains and sweat equity can also be treated appropriately by taxing carried interest as labor income while giving investors full deductibility.

OPTIONS FOR TAXING CARRIED INTEREST

Allocation of income between investors and managers

Suppose a fund generates $100 in long-term capital gains, and managers receive a 20 percent carried interest in any profits. For tax purposes, there are three basic ways to allocate that income among managers and investors (table 1).[15]

TABLE 1

Three Ways of Taxing Carried Interest

Tax treatment of $100 in fund gains when managers have a 20 percent carried interest

	Capital Gains	Labor Income or Ordinary Income
Current practice: Carried interest is capital income		
Manager	20	0
Investor	80[a]	0
Total	100	0
Partial reform: Carried interest is characterized as labor income		
Manager	0	20
Investor	80[a]	0
Total	80	20
Full reform: Carried interest is labor income & deductible from ordinary income		
Manager	0	20
Investor	100	-20[b]
Total	100	0

[a] 80 is the net capital gain, equal to a gross gain of 100 less 20 in carried interest.
[b] In this example, investors can fully deduct expenses; in practice, limits often apply.

- Under **current practice**, carried interest is treated as capital income. In our example, managers report $20 in capital gains and investors report $80 in capital gains (first section of table 1).
- Under **partial reform**, the carried interest managers receive is re-characterized as labor income, with no change for investors. This is the approach that many reformers, most notably President Obama (US Department of the Treasury 2016), have recommended.

[15] As noted earlier, Rosenthal (2013a, 2013b) suggests a fourth way, treating funds as developers, in which all fund returns would be treated as business income and none would be capital gains.

Under partial reform, managers report $20 in labor income, and investors report $80 in capital gains (second section).

- Under **full reform**, the carried interest managers receive is treated as labor income and is deductible against ordinary income for investors. Allowing such deductions is standard practice for taxpayers who incur investment expenses or are passive participants in businesses. Indeed, fund investors currently deduct from ordinary income the cash management fees they pay. Full reform simply extends that deduction to their carried interest as well. As discussed later, those deductions are subject to various limitations, but for now we focus on the case in which carried interest is entirely deductible. Under full reform, managers report $20 in labor income, and investors report $100 in capital gains and $20 in deductions against ordinary income (third section).

Full reform requires that we distinguish gross income flows, tracking the $100 in fund returns separately from the $20 in carried interest to managers. Doing the same for the other two approaches is straightforward. Under current practice, investors effectively receive $100 in gross capital gains and then immediately deduct $20 in carried interest, leaving a net capital gain of $80. The same happens under partial reform. Both current practice and partial reform thus give investors a deduction of carried interest against their capital gains income, while full reform gives a deduction against ordinary income.

This simple breakdown demonstrates that defenders of current practice are correct that partial reform can undermine standard tax benefits for capital gains. Under partial reform only $80 of gains get capital gains treatment, while the other $20 is treated as labor income. Partial reform thus overtaxes capital gains, relative to their treatment elsewhere in the economy.

But treating carried interest as capital gains is not the only way to treat capital gains appropriately. We can also preserve capital gains treatment for all gains by attributing all $100 in gains to investors and then treating carried interest as compensation paid by investors to managers. Full reform preserves capital gains treatment for all of the fund's returns, even though carried interest is taxed as labor income.

Tax rates of investors and managers

The carried interest debate primarily focuses on highly compensated fund managers, who raise money from endowments, pension funds, wealthy individuals, corporations, and other investors. For that reason, I focus on three main players—fund managers who fall in the highest tax bracket, private investors who fall in the highest tax bracket, and tax-exempt investors—and occasionally discuss a fourth, corporate investors.

For individual investors and fund managers, the top effective federal tax rate on long-term capital gains and qualified dividends is about 25 percent. That includes the 20 percent top statutory rate, the 3.8 percent net investment income tax, and the almost 1.2 percent effective marginal tax rate caused by a provision known as Pease that phases out the value of itemized deductions.[16]

Under current law, the top effective tax rate on labor income treated as self-employment income is 44 percent. That includes the 39.6 percent top statutory rate, the almost 1.2 percent Pease reduction in the value of itemized deductions, and an effective rate of 3.2 percent for Medicare taxes.[17]

The effective tax benefit for deducting expenses under current law depends on various factors, including the type of expense and associated limitations. For this initial analysis, I focus on cases in which expenses are fully deductible against both regular income taxes and the net investment income tax. As discussed later, this may be unrealistic in practice, but it is important for illuminating the forces at play. The relevant rate is 44.6 percent, reflecting the top statutory rate on labor income, the net investment income tax, and Pease.

Tax-exempt investors pay no tax on capital gains or other income and get no benefit from tax deductions. Corporate investors pay a 35 percent marginal rate on capital gains and other income and deduct expenses at the same rate. Unlike individual investors and fund managers, tax-exempt investors and corporations are indifferent about the character of their incomes; their capital gains and dividends face the same rates as other income sources.

Tax rates on funds with different types of investors

Given those tax rates, table 2 examines how the long-term capital gains of managers, investors, and funds overall are taxed under the three approaches.

The first section reports the relevant tax rates when investors are taxable individuals. Under current practice, fund managers pay 25 percent on their carried interest, and individual investors pay 25 percent on capital gains. Investors implicitly deduct carried interest at the capital gains tax rate. Overall fund gains are thus taxed at 25 percent.

Under partial reform, fund managers pay taxes at the 44 percent rate on labor income. Nothing changes for investors. Overall fund gains are thus taxed at 29 percent, 4 percentage points higher than under current practice. The additional 4 percentage points reflects the 19

[16] The effective tax rate may differ from 25 percent for various reasons. As discussed in more detail later, a loophole allows some fund managers to avoid the 3.8 percent net investment income tax. Once taxpayers have lost all their itemized deductions, the top rate is 23.8 percent. Taxpayers affected by the alternative minimum tax may face much higher marginal tax rates on their capital gains. And capital gains from investments in certain start-up companies, known as qualifying small business stock, are taxed at rates as low as zero.
[17] For taxpayers with high earnings, the Medicare tax rate is the regular 2.9 percent plus an additional 0.9 percent. Self-employed individuals deduct half the regular Medicare tax against their ordinary incomes. The effective rate is thus 3.2 percent (3.8 percent – 1.45 percent × 39.6 percent). At the income levels we consider here, managers are well beyond the range of the Social Security payroll tax, which currently applies to wages, salaries, and self-employment income up to $118,500.

percentage point tax increase on the 20 percent carry (19 percent × 20 percent = 3.8 percent, which rounds to 4 percent).

Under full reform, carried interest is taxed as labor income and fully deductible for investors. If investors and managers are both in the same tax bracket, as in this example, the deduction for investors effectively balances the tax increase for managers. Investors pay capital gains taxes on the fund's returns before deducting carried interest. Overall fund gains are thus taxed at 25 percent. The tax increase for managers is offset by a tax decrease for individual investors.

TABLE 2

Tax Rates under Three Ways of Taxing Carried Interest

Top tax rates on income, carry, and expenses from capital gains in a private equity fund (%)

	Manager	Investors[a]		Overall Fund
	Carried Interest	Capital Gains	Deduction for Carried Interest	All
Investors are taxable individuals				
Current practice	25	25	25	25
Partial reform	44	25	25	29
Full reform	44	25	45	25
Investors are tax-exempt organizations				
Current practice	25	0	0	5
Reform, full or partial	44	0	0	9
Investors are taxable corporations				
Current practice	25	35	35	33
Reform, full or partial	44	35	35	37

[a] Under current practice and partial reform, capital gains are net of carried interest, and the deduction is implicit. Under full reform, capital gains are gross, and carried interest is deducted explicitly.

The second section shows similar calculations when investors are tax exempt. Deductions have no value to tax-exempt investors, so partial reform and full reform are identical. Under current practice, overall fund returns are taxed at 5 percent (20 percent × 25 percent). Under partial or full reform, overall returns are taxed at 9 percent. The 4 percentage point increase is identical to that under the partial reform case with individual investors.

The third section shows similar calculations for a corporate investor. Deductions do have value for corporations. But corporations are indifferent to whether they take those deductions against their capital gains or other forms of income. Partial reform and full reform thus have identical effects. Under current practice, overall fund returns are taxed at 33 percent. Under partial or full reform, they are taxed at 37 percent, 4 percentage points higher.

For each type of investor, treating carried interest as labor income increases taxes on fund returns by 4 percentage points. Allowing investors to deduct carried interest against ordinary income has no effect for tax-exempt and corporate investors. For taxable individuals, however, a full deduction for carried interest offsets the tax increase on managers. Full reform thus increases taxes on fund returns by 4 percentage points for tax-exempt and corporate investors, but leaves overall taxes unchanged when investors are taxable individuals.

THE BENEFITS OF FULL REFORM

Full carried interest reform—treating it as labor income to managers and as deductible against ordinary income for investors—has five main benefits.

First, full reform accomplishes the primary goal of the labor services view, taxing carried interest as labor compensation. Wealthy fund managers no longer pay lower tax rates on their carry than many Americans do on their wages and salaries.[18]

Second, full reform accomplishes the primary goal of the entrepreneurship view, maintaining existing tax preferences for long-term capital gains and qualified dividends. Partial reform eliminates preferential rates for any capital gains and dividends distributed to managers as carried interest. Full reform, however, attributes all of a fund's pre-carry returns to investors and thus maintains preferential rates for all the capital gains and dividends that funds generate.

Third, full reform eliminates the tax arbitrage identified by the joint tax view. Tax preferences for capital gains and dividends are intended to benefit individual investors, not endowments and pension funds (which pay no taxes) or corporations (which pay the same tax rates on capital gains as on other income). Today, carried interest allows individual investors to sidestep those restrictions. Tax-exempt investors and corporations may not directly benefit from preferential rates themselves, but they indirectly benefit by transferring a portion of their capital gains and dividends to individual fund managers who do value the tax preference. Taxing carried interest as labor income eliminates this arbitrage.

Fourth, full reform eliminates tax distortions in manager compensation. Current practice favors carried interest over cash compensation. Managers get the lower tax rates on capital income, but many of their investors do not bear an offsetting burden. That distorts compensation arrangements to favor carry over management fees or cash awards based on fund performance. In addition, the rate differential inspires fund managers to convert management fees into tax-favored carry, in some cases without taking on the risks—or experiencing the incentives—that real carried interest entails.[19] Treating carried interest as labor income, while providing full deductibility for investors, eliminates both these distortions. Investors and managers could thus

[18] As discussed later, treating carried interest as labor income also prevents managers from exploiting a loophole that could allow their income to avoid both self-employment taxes and the 3.8 percent net investment income tax.
[19] Polsky (2015) documents managers' efforts to convert management fees into carry and other tax games they play.

design compensation arrangements based on investment management considerations, not taxes.[20]

Finally, full reform rewards managers who put more skin in the game. Managers of large funds may contribute as little as 1 percent of a fund's total capital. But investors often prefer larger contributions that more closely align manager incentives with investor returns.[21] Investors might therefore prefer a compensation structure with more manager investment, less carried interest, and more management fees. But current practice discourages such arrangements by taxing management fees more heavily than carried interest. Taxing carry as labor income eliminates that distortion. As a result, managers benefit from the lower rates on capital gains and dividends only to the extent they themselves invest in their fund.

THE EFFECTS OF REFORM ON INVESTMENT BY PRIVATE EQUITY FUNDS

Some commentators worry that carried interest reform will decrease investment by private equity funds. The basis for that worry is easy to understand. Taxing carried interest as ordinary income reduces fund managers' take-home pay. Some managers might therefore pursue other activities rather than raise new funds. Others may pass some or all of the tax increase through to investors as higher fees, possibly prompting investors to reduce fund investments.

However, the full effect on investment depends on how reform affects investors. If all the fund's investors are taxable individuals who can fully deduct carried interest against ordinary income, full reform will have no effect on its after-tax returns. Any tax increase on managers is offset by a tax decrease on investors. In fact, a fund with taxable investors can structure manager compensation to have the same economics and incentives after full reform. Carried interest of 27 percent,[22] for example, gives both managers and investors the same after-tax returns after full reform as carried interest of 20 percent does today.[23]

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[20] Throughout this paper, I focus on the character of carry, that is, whether it is treated as capital income or labor income. As Sanchirico (2008) and others have noted, carried interest also raises issues about deferral. From a joint tax perspective, deferral matters for tax-exempt and corporate investors but not for taxable individuals, since any deferral benefits for managers are offset by deferral costs of investors. With interest rates at exceptionally low levels, deferral is a much smaller issue than character. If a fund holds an investment for five years, for example, then the amount of deferral might average about two and a half years, depending on when portfolio company values grow. With two- and three-year Treasury interest rates averaging around 1 percent annually, that equates to about a 1 percentage point reduction in taxes on carried interest (44 percent × 1 percent × 2.5 years) versus the 19 percentage point difference between capital and labor tax rates. Deferral is more valuable for venture funds with longer holding periods, but even then it is only a fraction of the importance of character. Deferral is equally true of a compensation structure that pays managers a fraction of deal profits in cash. Deferral is thus a feature of performance pay, rather than of carried interest per se.

[21] Mulcahy, Weeks, and Bradley (2012) discuss these issues from the endowment manager's perspective, arguing that managers should invest more in their own funds.

[22] 20 percent × (1 − .25) / (1 − .44) ≈ 27 percent.

[23] This relationship is not exact because of the small gap between the 44 percent effective tax rate on labor income and the 44.6 percent effective tax rate on full deduction of investment expenses. Because of that gap, which reflects a slight difference in how we collect Medicare taxes relative to how we collect the net investment income tax, full reform actually reduces taxes slightly on funds with all taxable investors. With 20 percent carry, the tax rate falls from 25.0 percent to 24.9 percent. If carry rose to 27 percent, the tax rate would be 24.8 percent.

Treating carried interest as ordinary income does, however, increase taxes on overall fund returns when investors are tax-exempt institutions and corporations. For those investors, increased taxes on managers are not offset by increased investor deductions. And the resulting increase is larger if fund managers demand a higher rate of carried interest. For funds relying on these investors, we should therefore expect some reduction in fund investments. But any reduction reflects the rolling back of the subsidy to these investors in current practice, not the introduction of a new tax burden. Moreover, tax-exempt and corporate investors would likely invest their resources through other channels, thus limiting any effect on investment in the larger economy.

GIVING INVESTORS CREDIT FOR PAYING CARRIED INTEREST

Under current practice, investors do not get a specific deduction for carried interest. Instead, carried interest is subtracted from fund returns before investors receive them, and investors pay taxes on those net returns. Under partial reform, investors receive the same treatment, implicitly deducting carried interest against their gross capital income.

Under full reform, investors pay capital income taxes on a fund's gross returns and then explicitly deduct carried interest from their ordinary income. In principle, that gives taxable individual investors full tax credit for the carry they pay. In practice, however, the tax code often limits investors' ability to make full use of such deductions. It is therefore worth considering three ways of giving investors a deduction for the carried interest they pay: treating it as an investment expense, treating it as a business expense, or allowing current practice for funds that do not raise the same policy concerns as do large private equity funds.[24]

Funds as investors

For tax purposes, private equity funds are traditionally viewed as a type of investor. As a result, individuals who participate in a fund can deduct any associated costs as investment expenses. That's what happens with the cash management fees fund investors pay today.[25] Under full reform, it is natural to do the same for carried interest. Compensation structured as carried interest then receives identical tax treatment as compensation paid in cash.

But investment expenses are currently deductible only to the extent that miscellaneous itemized deductions—which include investment expenses, tax preparation fees, and unreimbursed employee expenses among other items—exceed 2 percent of a taxpayer's adjusted gross income. Taxpayers who exceed that floor with existing expenses get full tax deductibility of

[24] Another approach is to introduce a new tax on investment returns to tax-exempt institutions, corporations, and other investors indifferent about the character of their income. In principle, such a tax, similar in spirit to the unrelated business income tax levied on certain investments by tax-exempt institutions, could eliminate the tax arbitrage identified by the joint tax view.
[25] See, for example, Debevoise & Plimpton (2015).

their carry under full reform. Taxpayers who fall short, however, can deduct only that carry that exceeds the floor. For some investors, that is nothing.[26]

Because of this limit, some investors do better under partial reform than under full reform. Partial reform allows investors to implicitly deduct carried interest against their capital income without limit, while full reform allows them to explicitly deduct carried interest against ordinary income subject to the 2 percent floor. If the effective tax rates on capital income and deductions are 25 percent and 45 percent, respectively, full reform will be more attractive to investors only if they can deduct at least 56 percent of their carry.[27]

From an investor's perspective, partial reform treats carried interest and cash performance fees differently. Carried interest is netted against gross fund returns, while cash performance fees are deductible as miscellaneous itemized expenses. That difference gives funds some flexibility to tailor their compensation structure to their individual investors' tax preferences. If investors can deduct the majority of their investment expenses, funds could pay cash performance fees instead of carry. If investors cannot deduct the majority of their investment expenses, in contrast, they could continue to provide carried interest.

Funds as businesses

As noted earlier, some analysts and courts have recently argued that funds should be viewed as businesses, not investors. Under that view, fund investors would treat management fees as business expenses, not investment expenses. Under full reform, the same is true for the carried interest they pay.

Individuals who invest in funds can deduct business expenses against other income from passive investments. If they do not have enough passive income one year, they can carry unused deductions forward until a future year in which they have enough income or dispose of their ownership positions. Those limitations may thus defer investors' ability to deduct the carried interest they pay fund managers. But not indefinitely. Eventually, investors can deduct the full amount of the carried interest they pay. The passive loss limitations can thus reduce the value of deductibility but do not eliminate it, as can happen with the limits on investment expenses.

Treating funds as businesses is a reasonable way to implement full reform. But there are two caveats.

First, treating funds as businesses today, without making other changes to the tax treatment of carried interest, expands a loophole for capital income resulting from an active business. Under current law, carried interest to managers actively engaged in the fund business

[26] Investors also lose the deduction if they are subject to the alternative minimum tax.
[27] 25 percent / 44 percent ≈ 56 percent.

is subject to neither self-employment tax nor the 3.8 percent net investment tax.[28] From what appears to be a mistake in its original drafting, the net investment income tax does not apply to capital income that managers receive from a business in which they are actively engaged. In principle, lawmakers should correct that error for all types of active businesses. For funds treated as businesses, however, the problem can also be solved by treating carried interest as labor income subject to self-employment taxes.

Second, treating funds as businesses helps investors only if their capital gains and dividends continue to be treated as capital income. Under the developer theory of private equity, however, that income is treated as business income.[29] As a result, no fund returns qualify for lower tax rates on capital gains and dividends. Critiquing the developer theory is beyond the scope of this paper. For my purposes, it is sufficient to note that full reform requires that fund income continue to be treated as capital income, even when funds are viewed as businesses.

Safe harbor for small funds involving only taxable investors

Like most tax policy observers, I have a strong preference for a simple tax code that draws as few unnecessary distinctions as possible. For completeness, however, note that the arguments for taxing carried interest as labor income are most compelling for large funds whose managers are often exceptionally wealthy and whose investors are often tax-exempt or otherwise indifferent to the character of income they receive.

Those arguments have much less force when managers are less wealthy, funds are smaller, and investors are all taxable individuals. Consider angel syndicates.[30] Some are certainly led by wealthy individuals. But others are led by what you might describe as successful professionals—well off by any plausible standard, but not to the same degree of social concern as top fund managers. Their investors are taxable individuals, not institutions that benefit from tax arbitrage. Moreover, angel syndicates tend to be small—on the order of $1 million, not the $500 million or more of leading funds—and thus do not generate the same potential income.

Policymakers have often decided that small, innovative businesses should receive simpler or more favorable tax treatment than larger ones. That option is available with carried interest as well. Policymakers could, for example, establish a safe harbor for funds like angel syndicates that have only taxable investors and are relatively small. Such qualifying funds pose neither the tax arbitrage concern highlighted by the joint tax view, nor the social equity concern highlighted by the labor services view. Policymakers could allow such small funds to continue to give managers

[28] Elias (2013) examines this loophole for real estate fund managers; the same logic applies to private equity funds treated as a trade or business.
[29] As developed by Rosenthal (2013a, 2013b), the developer theory has two pieces. First, it argues that funds are engaged in a trade or a business, a view that strikes me a quite reasonable. Second, it argues that funds are engaged in the functional equivalent of developing property and selling it to customers. That strikes me as unreasonable, at least as a matter of economics and policy. The buyers of the stock are investors, not customers.
[30] Disclosure: When this paper was published, I was evaluating whether to invest in an angel syndicate.

carry taxed as capital gains, while carry at larger funds and funds with tax-exempt investors is taxed as labor income.

CONCLUSION

Debate has long focused on how to tax fund managers who receive carried interest. We should also think carefully about how we give tax credit to the investors who pay that carried interest. People should be able to deduct the expenses they incur in efforts to generate income. If managers pay labor taxes on the carried interest they receive, investors should deduct from ordinary income the carried interest they pay.

This full reform reconciles the three leading perspectives on carried interest. It taxes carried interest as labor income, as implied by the labor services view. It eliminates the tax arbitrage identified by the joint tax view. And it ensures that all of a fund's long-term capital gains and qualified dividends are taxed at the same rates as capital gains and dividends throughout the economy, as implied by the entrepreneurship view. Full reform thus allows Goldilocks to eat her porridge and have it too: carried interest taxed as labor income while providing all the usual tax incentives for entrepreneurship and sweat equity.

Full reform should therefore resolve debate about the principles that should guide carried interest reform. Attention should now focus on the details of implementation, with particular emphasis on how investors get credit for carried interest. Treating funds as businesses while allowing them to continue passing capital income through to investors is a reasonable approach.

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