NATIONAL CENTER FOR POLICY ANALYSIS

Taxing Carried Interest

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Over the past several years, there has been much debate about how to tax the compensation of the managers of private equity, venture capital and hedge funds. The issue is important because these funds provide capital for businesses at various stages of development or seek to minimize risks for investors, and raising taxes on these funds would reduce the rate of return to fund investors.

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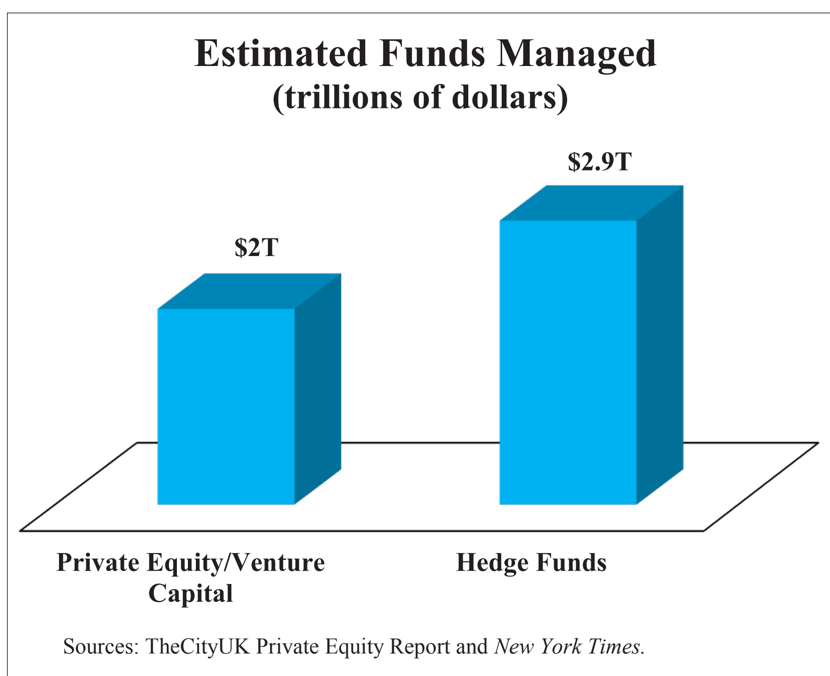
- Private equity funds, which own interests in companies that are not publicly traded, managed an estimated $2 trillion in worldwide assets in 2013, according to TheCityUK, a financial services organization. Venture capital funds, a type of private equity fund which specialize in startup ventures, invested about $60 billion in 2015, according to the National Venture Capital Association.
- Hedge funds, which pool capital from accredited investors and reduce the risk of losses by short selling against a long-term investment plan, managed an estimated $2.9 trillion in assets worldwide in 2015, according to the *New York Times*. [See the figure.]

These funds are usually organized as partnerships and are managed by one or more of the partners. The general managing partners receive a flat fee (salary) from the other partners and/or an ownership interest which entitles them to a share of the profits upon sale of the fund's assets, called "carried interest." This portion of the fund manager's compensation carries risk: They do not receive it unless the fund gains value, and even then, they may have to wait to receive it until assets are sold. Some hedge fund managers are very wealthy — the top 25 hedge fund managers earned $13 billion in compensation last year, according to the *New York Times*. However, many other hedge funds are much less successful or even fail, in which case the managers receive little or no carried interest.

Taxation of Carried Interest. The flat fee portion of the general partner's compensation is taxed as personal income. The highest marginal rate for personal income is 39.6 percent. However, the manager's profit share (the carried interest) is typically taxed at the top long-term capital gains tax rate of 20 percent (plus a 3.8 percent Medicare surtax on unearned income). Many have proposed taxing carried interest as ordinary income — but consider some of the implications of such a policy change:

- Decreasing the "take-home pay" of fund managers by increasing their tax rate would require them to take a higher percent of the fund's value to maintain the same post-tax compensation level. This would be taken from the other partners in the fund (such as schools, pension plans, and so forth), and therefore harm middle class savers who invested in the fund.
- Tax-exempt partnerships (charities, schools and so forth) would be disproportionately affected by increases in the carried interest tax rate, as they are unable to write off fund management expenses as tax deductions.



Sources: TheCityUK Private Equity Report and *New York Times.*

A 2013 Commonfund Institute survey revealed that charities, foundations and university endowments invest 25 percent to 50 percent of their portfolio in assets managed by private equity and hedge funds.

- While the current system results in some "lost" tax revenue, it only amounts to, at most, $15.6 billion over 10 years, according to the Joint Committee on Taxation, or 0.04 percent of total projected tax revenue over the period. Comparing this to the amount of money managed by these types of funds (around $5 trillion) and considering the risk involved further reveals just how minute this issue truly is.
- The carried interest tax base could shrink if it is taxed at a higher rate than capital gains because investors would have less of an incentive to make investments in these types of funds and instead might shuttle their resources into areas where they will be taxed at the lower capital gains rate.

Notably, the opposite occurred following the 2003 capital gains tax *cut*: Actual capital gains tax revenue outpaced Congressional Budget Office (CBO) projections dramatically as more investors became more willing to risk investing money in these types of funds and ventures following the tax cut.

Proposals for Change. During the 2016 election cycle, presidential candidates across the political spectrum have targeted carried interest taxation as a potential change in the tax code. Major presidential candidates called for taxing carried interest as personal income, but at different rates. Donald Trump, Ted Cruz, Hillary Clinton and Bernie Sanders have all offered plans:

- Hillary Clinton has proposed a surtax of 4 percent on income over $5 million per year, which effectively increases the top marginal rate to 43.6 percent. The Medicare surtax on unearned income would also apply, pushing the tax rate on fund managers' compensation to 47.4 percent.
- Bernie Sanders' plan called for a top rate of 54.2 percent, including his proposed health care tax of 2.2 percent on all income.
- The Trump plan would also tax carried interest as income, but calls for income tax rates to decrease. The top marginal rate in the Trump tax plan is 25 percent, and it removes the Medicare surtax to return the top capital gains rate to 20 percent.
- Ted Cruz proposed a flat tax of 10 percent on income and capital gains. An equal tax on income and capital gains would make the carried interest issue moot.

Effect on Entrepreneurship. Depending on which businesses are classified as "startups," it is estimated that up to 25 percent of pre-initial public offering (pre-IPO) startup funding comes from private equity or venture capital backers. Increasing the tax burden on these entities would damage a valuable access-to-capital pipeline for some startups — particularly in the energy, technology and biotech sectors where large up-front investments could be required.

Given that less than 50 percent of startup businesses succeed, according to a Kauffman Foundation survey, there is a substantial risk that the fund managers in these cases will receive nothing. Taxing carried interest as personal income could only be neutral with respect to economic growth if personal income tax rates are also reduced substantially.

Conclusion. The Clinton and Sanders plans to increase income tax rates *and* require carried interest to be taxed as income would decrease both the amount of capital available to be invested and the incentive for expert investors to become involved in these projects, and increase the marginal cost of investment for other fund partners. In contrast, reducing overall income tax rates would increase the amount of private money available for investment.

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