What is Carried Interest Capital Gains?

Center Forward Basics

September 2021

Overview

Carried interest is a frequently discussed aspect of limited partnerships — a type of partnership frequently used for the purpose pooling together capital to invest. While the focus is often on the financial sector, carried interest and limited partnerships are quite common across the country, including mom-and-pop landlords, shopping centers, and windmill farms. Limited partnerships are formed to invest in assets in nearly every industry and use carried interest as an incentive to align the interest of all partners. Many of these partnerships are structured in a way so that the General Partner retains an ownership interest in the partnership's profits, known as a carried interest, which entitles the General Partner to a proportion of the partnership's profits. If the character of the partnership's income is a capital gain, then the general partner's income attributable to the carried interest is a capital gain and taxed as such. As Congress considers the reconciliation package, there are several proposals to change the tax treatment of carried interest capital gains. This Basic will explain how carried interest capital gains are taxed and the tax principles in play.

Carried Interest

In a limited partnership, a General Partner (GP) will invest their money and entrepreneurial expertise into a business — usually an enterprise that the GP has considerable expertise. The Limited Partner (LP) will invest their money and have minimal control over business and investment decisions. In many cases the GP will receive a management fee to pay for ordinary business expenses of the partnership, including salary— the management fee is taxed as ordinary income. If successful in growing the business, the limited partnership will eventually seek to sell the company, at the direction of the GP, for a higher value than it was purchased for— this typically occurs after years of growth and investment. Through this transaction, the LP investors are entitled to the capital they contributed, and the lion's share of profits from the sale. The GP will realize a carried interest capital gain equal to their share of the partnership, which is negotiated amongst the partners before forming the partnership. In some limited partnerships, such as private equity funds, the limited partnership must meet a minimum rate of return, the hurdle rate, before the GP realizes a carried interest capital gain. In these vehicles, general partners are subject to claw backs of their carried interest capital gains if the limited partnership fails to meet the minimum rate of return.

An example where the LP provides the money and the GP invests entrepreneurial expertise in return for a carried interest is:

- A chef wants to start a restaurant with their expertise in cooking and restaurant management, but the chef does not have money to start the

Center Forward Basics

Center Forward brings together members of Congress, not-for profits, academic experts, trade associations, corporations and unions to find common ground. Our mission: to give centrist allies the information they need to craft common sense solutions, and provide those allies the support they need to turn those ideas into results.

In order to meet our challenges we need to put aside the partisan bickering that has gridlocked Washington and come together to find common sense solutions.

For more information, please visit www.center-forward.org

Key Facts

- **General Partner investor (GP):** establishes and runs the investments.
- **Limited Partner investors (LP):** LP investors contribute most of the money for an investment.
- **Hurdle Rate:** the negotiated minimum rate of return that General Partners must meet prior to realizing carried interest. The hurdle rate on a private equity fund is negotiated during fundraising between the GP and LPs in the fund.
- **Management Fee:** A fee received by the General Partner in exchange for managing the partnerships.
- **Clawback:** A provision in the partnership agreement which requires the general partners to return carried interest capital gains to the partnership if the minimum rate of return is not met.

venture. The chef finds LPs who provide the money so that they can use their expertise to start the venture. The chef as the general partner may receive a management fee for managing the partnership, which is taxed as ordinary income. If the business is successfully grown after many years and the partnership exits through a sale, the chef receives a carried interest worth 20% of the profits from a sale of the venture—only after limited partners are returned their capital. These profits are taxed at capital gains rates.

Taxation

Generally, the U.S. tax code treats income received from labor/services as ordinary income—with rates currently ranging from 10% to 37%. The U.S. tax code taxes long-term capital gains (held more than one year or in the case of carried interest capital gains more than three years) at 20%. An additional 3.8% net investment income tax (NIIT) may apply in certain scenarios. In most cases short term capital gains are taxed as ordinary income. The preferential treatment for long-term capital gains is intended to encourage entrepreneurial risk taking and long-term investment.

Carried interest capital gains are treated as such because the income is generated from the sale of capital assets, such as, businesses. The tax code has always treated carried interest on the sale of capital assets as capital gains income. However, the Tax Cut and Jobs Act of 2017 specifically extended the carried interest holding period to 3-years to obtain long-term capital gains treatment. Any carried interest capital gains income attributable to an asset held for fewer than 3-years is taxed as short-term capital gains. Generally, this tax law provides incentives for GPs (i.e. venture capital firms, private equity, real estate development firms, etc.) to take risks and invest in businesses over the long-term. Partnerships use the carried interest to align the interests of investors— this is an incentive to grow companies.

Proposals have been introduced in Congress to recharacterize carried interest capital gains as ordinary income since the early 2000s, when former Ways & Means Committee Chairman Sandy Levin introduced what is now the "The Carried Interest Fairness Act." The current House version, H.R. 1068, introduced by Representative Bill Pascrell (D-NJ), has 13 cosponsors while the current Senate version, introduced by Senator Tammy Baldwin (D-WI), also has 13 cosponsors. In August 2021, the Senate Finance Committee Chairman Ron Wyden (D-OR) and Senator Sheldon Whitehouse (D-RI) re-introduced a separate proposal, the Ending the Carried Interest Loophole Act, that proposes to increase taxes on carried interest by deeming the investments as loans and requiring immediate recognition and taxation of the funds even though profits have not yet been realized and are not certain to be realized. The bill has no other cosponsors.

In the Biden Administration's Build Back Better proposal, carried interest would be taxed at rates as high as 39.6%, instead of the current rate of 20%, a 98 percent tax increase on carried interest capital gains. They also proposed a top tax rate of 39.6%, up from 37%, for those earning $1 million or more.

In 2018, the Joint Committee on Taxation (JCT) scored the Pascrell/Baldwin Carried Interest Fairness Act at $14 billion over 10 years. However, the Biden Administration's proposal in the Greenbook scored it at $1.4 billion over 10 years since a significant amount of the carried interest associated tax revenue decreases as the broader capital gains rates are increased. JCT estimates that the Wyden/ Sheldon Whitehouse proposal would raise $63 billion over ten years. Congress and the Biden Administration will continue to determine the tax proposals in the coming weeks.

Opponents of the changes argue it would harm investors and investment funds—creating tax distortions. A corporation, for example, would still receive capital gains treatment in a subsidiary investment while an investor would be taxed at a 98% disadvantage. Opponents argue this could harm the growth and scaling of disruptive businesses. Additionally, opponents of the tax increase argue the new preferential treatment of those with capital compared to those without capital would harm broader entrepreneurship and efforts for an inclusive economy.

Links to Other Resources

- Bloomberg — Carried Interest Tax Break Unites PE Firms as Congress Takes Aim
- Congressional Research Service — Taxation of Carried Interest
- Eisner Amper — Wyden's "Ending the Carried Interest Loophole Act" Would Require Annual Ordinary Income Inclusions
- Financial Regulation News — Sens. Wyden, Whitehouse introduce bill to close carried interest loophole
- The Street — What is Carried Interest and How Does it Work?
- Tax Policy Center — What is Carried Interest, and How is it Taxed?
- University of Chicago — Professor Says Carried Interest Legislation Is Misguided
- Warren Averett — Carried Interest Tax Considerations