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Will the "Carried Interest" Loophole Finally Be Closed?

Lobbyists Line Up to Request a Carve-Out for their Clients

Carried interest is the share of profits that investors pay to compensate certain people for managing their money. The investment managers who receive carried interest have been allowed to pretend that this compensation represents profits on money they have invested themselves, thus entitling them to pay taxes at the low capital gains rate of 15 percent rather than the regular rate of 35 percent that other highly compensated workers pay.[1]

Three times the House has voted to close the "carried interest" loophole and three times the Senate has failed to pass the provision. The latest version of the loophole closer was included in the "tax extenders," a bill extending expiring tax breaks, approved by the House on December 9. The Senate left the carried interest provision out of its version of the extenders bill, which they passed on March 10, and instead offset the costs of the tax breaks with a provision closing the "black liquor" loophole. However, that provision wound up in the final healthcare package, leaving the Senate extenders bill without enough revenue to cover the costs.

Senate Finance Committee Chairman Max Baucus indicated last week that "carried interest will probably be part of the offsets." That released a flurry of lobbying activity by taxpayers trying to hold onto their favored status.

"Carried Interest" Explained

Managers of investment partnerships like private equity funds, venture capital funds, real estate partnerships, and oil and gas partnerships are often compensated with an arrangement known as "two and twenty" (although terms may vary): they receive a management fee of 2 percent of assets under their management and 20 percent of any profits (above some agreed "hurdle" amount). In other words, they get a 20 percent interest in the deal that they don't have to pay for (the other partners pay for, or "carry," the manager's interest). The management fee is taxed as ordinary income at rates up to 35 percent, but income from the carried partnership interest is generally taxed at the special, low 15 percent rate for capital gains.

Investment Managers Should Pay Ordinary Rates on Compensation Like Everyone Else

The preferential income tax rate for capital gains was created to benefit those who invest their own money. The partnership income that investment managers earn is clearly compensation for

[1] The top rate for capital gains is scheduled to go up to 20 percent in 2011 while the top rate for ordinary income is scheduled to go up to 39.6 percent. If the carried interest loophole is still in place next year, investment fund managers will be avoiding almost the same amount of tax as they do now (20 percent) on their carried interest.

services and not a return on investment (except to the extent that they actually have put up their own money—and the treatment of that won't change). They should pay income taxes at ordinary rates on their compensation, just like everyone else, from the folks who sweep their floors or answer their phones to CEO's exercising stock options and professional athletes getting playoff bonuses. As Warren Buffet famously pointed out, his secretary should not be paying a higher tax rate than he is (he's paying 15 percent, while his secretary is likely in a 25 percent income tax bracket and paying payroll taxes on top of that).

Don't We Want to Encourage Venture Capital?

The venture capital industry is lobbying for a carve-out from the carried interest provision. They point out they foster small business, encourage innovation, and create jobs, so we don't want this type of investment to dry up. It's a tempting argument, but try to see through the smoke. The change affects only *the managers* of venture capital funds. It doesn't change how the *investors* are taxed. The managers will take home less cash, but they still have plenty of incentive to work hard and make the fund successful—remember that 20 percent interest they get, plus the 2 percent management fee. The venture capitalists provide important services, but no more important than the teachers who educate our kids to create the next round of innovations. Teachers' salaries shouldn't be taxed at higher rates than venture capitalists' compensation.

Won't It Hurt the Real Estate Industry? What About Oil and Gas Partnerships?

Congressional Republicans have reportedly said that the carried interest loophole closer will impose a 133 percent tax increase on real estate partnerships. Is the smoke burning your eyes yet? It's true that 35 percent (the top rate that other rich people pay on their wage income) is 133 percent of the top capital gain rate of 15 percent, but *the carried interest provision applies only to the managers* of the real estate and oil and gas partnerships. It has NO effect on the partnership itself or on the partnership's investors. Maybe in future deals the managers will try to negotiate more compensation to make up for their tax increase, but probably not. The two-and-twenty compensation arrangement has been around for a long time and it didn't change when capital gain tax rates went *down* in 1997 and 2001. The current tax treatment of carried interest is just a windfall for the investment managers. Realtors and oilfield workers pay ordinary rates on their compensation and get capital gain treatment only when they invest their own money. The investment managers should play by the same rules.

Carried Interest Loophole Will Strengthen Momentum to End Capital Gains Preference

Supporters of the capital gains tax preference should support closing the carried interest loophole. The arguments for eliminating the capital gains preference entirely are compelling. To the extent that Congress leaves in place loopholes that allow people to disguise their compensation as capital gains in order to take advantage of the preferential rate, that only gives us additional arguments against the capital gains preference when Congress turns to fundamental tax reform. And given our country's fiscal crisis, that might happen sooner than you think.

For more information, see:
"Myths and Facts about Private Fund Managers – and the Tax Loophole They Enjoy," July 2007, http://www.ctj.org/pdf/privateequity071907.pdf.
"Congress Should Stop Subsidizing Millionaires Through the Tax Code," November 2007, http://www.ctj.org/pdf/carriedinterestfacts.pdf.
"Real Estate and the Carried Interest Loophole," November 2007, http://www.ctj.org/pdf/holtzeakin.pdf.