There is No Carried Interest Loophole

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How are funds taxed?

- Funds are partnerships
  - Partnership taxes are hard!

- In general, income **"flows through"** the partnership and is taxed to the partners as if they earn it directly
  - **Interest** to the fund is taxed as **interest** to the partners; **long-term capital gain** (preferentially taxed income) generated by the fund is taxed as **long-term capital gain** to the partners; etc.
  - Contractual flexibility in allocating income, but rules also exist to ensure allocations of income to the partners match the economics

What is Carried Interest (or Carry)?

- Carried interest is a **special allocation** of income to a private equity (PE) or hedge fund general partner (GP)
  - I take a U.S. tax perspective here

- Special allocations are allocations of income **disproportionate to ownership**
  - e.g., 2% ownership, 20% income allocation

- Because partnership income "flows through," not all carry is cap. gain!
  - Hedge funds; private debt

What is a Loophole?

- A **loophole** is an inadequacy in a law that can be used to circumvent or otherwise **avoid** the purpose of the law
  - Given identical transactions, only a subset of taxpayers benefit

- Commentators often label **perfectly legal** or intentional tax **incentives** that apply to all taxpayers as "loopholes"
  - Net operating losses (e.g., Amazon)
  - Bonus depreciation
  - Capital gains (preferential) tax rates

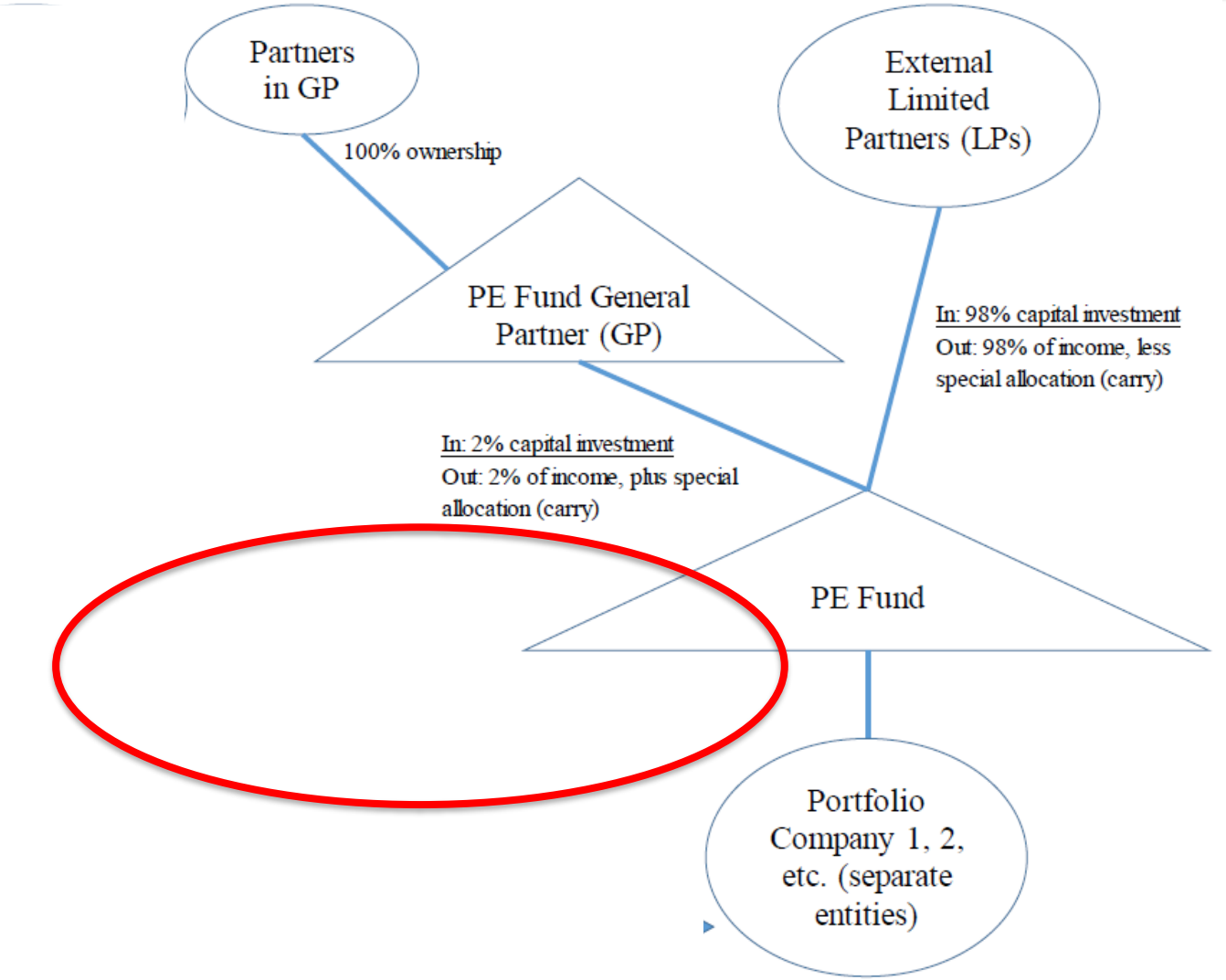
Why is Carried Interest a “Loophole”?

- Allows income that should be **ordinary** (e.g., income from working - faces higher tax rate) to be taxed as **capital** (faces lower tax rate)
  - Tax break for “rich people”
  - Deprives the government of tax revenue

- “Unfair”
  - **Exclusive** benefit for “rich people”

- But is this narrative really true?

Structure


Partners in GP
100% ownership
External Limited Partners (LPs)
PE Fund General Partner (GP)
In: 98% capital investment
Out: 98% of income, less special allocation (carry)
In: 2% capital investment
Out: 2% of income, plus special allocation (carry)
PE Fund
Portfolio Company 1, 2, etc. (separate entities)

Why is Carried Interest Not a Loophole?

- Fair
  - Ensures **equal treatment** of income regardless of structure
  - Compensation for services paid through (high) management fee
  - "Rich people" should face a higher tax **rate** if that is the issue

- Similar outcomes can be achieved using classes of corporate stock

- May increase, or at least not significantly decrease, government revenue

Fairness – Sale of Capital Asset Example

	Direct Ownership (1)
Owners' Investment:	
Homeowner	$400,000
A	
B	
C	
D	
Total Invested	400,000
Sales Price	500,000
Gain	100,000
Owners' Income:	
Homeowner	100,000
A (20% carry in col. 3)	
B	
C	
D	
Taxable Gain	100,000
Tax Rate	23.8%
Tax Due	**23,800**

- Carried interest shifts a portion of income and gains
  - **Horizontal** equity
- If the concern is that the **management fee** is too low (or outright abuse), the tax authority can litigate on that issue

- Well, what if Elon Musk is Partner A and gets a carry? Then it's unfair! Partner A should pay more!

- But A may or **may not** be Elon Musk. If the concern is that the Elon Musks don't pay enough tax, then **tax rates** should change so that Elon pays a higher rate whether he is A, B, C, or D
  - **Vertical** equity

Counterarguments

- Carry arises from some sort of **effort**
  - So do home price appreciation and stock picking gains

- PE portfolio companies should be treated as **inventory** because they are bought to be sold
  - If so, same argument applies to stocks and real estate

- Disguised management fee or vertical equity issues (discussed on prior slide)

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Fairness – Equivalence to Corporate Stock

- Corporate stock structure with **classes** of preferred stock
  - "Preferred return" class, "carry" class, "residual" class
  - Unlike carry, stock sales or dividends nearly always generate preferential income

- "83(b)" election
  - **Employees** compensated with stock options can pay ordinary tax on the options' current value (e.g., $0 for a startup) and obtain capital gain taxation on future increases in value
  - Even if carry were compensation, the treatment is equivalent

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Higher Government Revenue?

	Partnership	Partnership with Carry
	(1)	(2)
Owners' Investment:		
A	$100,000	$100,000
B	100,000	100,000
E (exempt)	100,000	100,000
F (foreign)	100,000	100,000
Total Invested	400,000	400,000
Sales Price	500,000	500,000
Gain	100,000	100,000
Owners' Income:		
A (20% carry in col. 2)	25,000	40,000
B	25,000	20,000
E (exempt, no U.S tax)	25,000	20,000
F (foreign, no U.S. tax)	25,000	20,000
Taxable Gain	50,000	60,000
Tax Rate	23.8%	23.8%
Tax Due	**11,900**	**14,280**

- Carried interest may **shift income** from nontaxable investors (from a domestic perspective) **to** the taxable GP

Treat Carry as Ordinary Income?

- Many commentators think treating carry as **ordinary** will increase taxes by the difference between the ordinary and preferential tax rates

- Reality is more complex
  - Some carry is **already** taxed as ordinary (ST gains, interest, etc.)
  - Treating carry as ordinary income can lead to an **offsetting** ordinary deduction
    - Could generate an additional deduction at a 21% rate and additional income at only a 17% rate (other scenarios exist)

Result of Treating Carry as Ordinary

Alternative Taxation of Carry as Ordinary Income

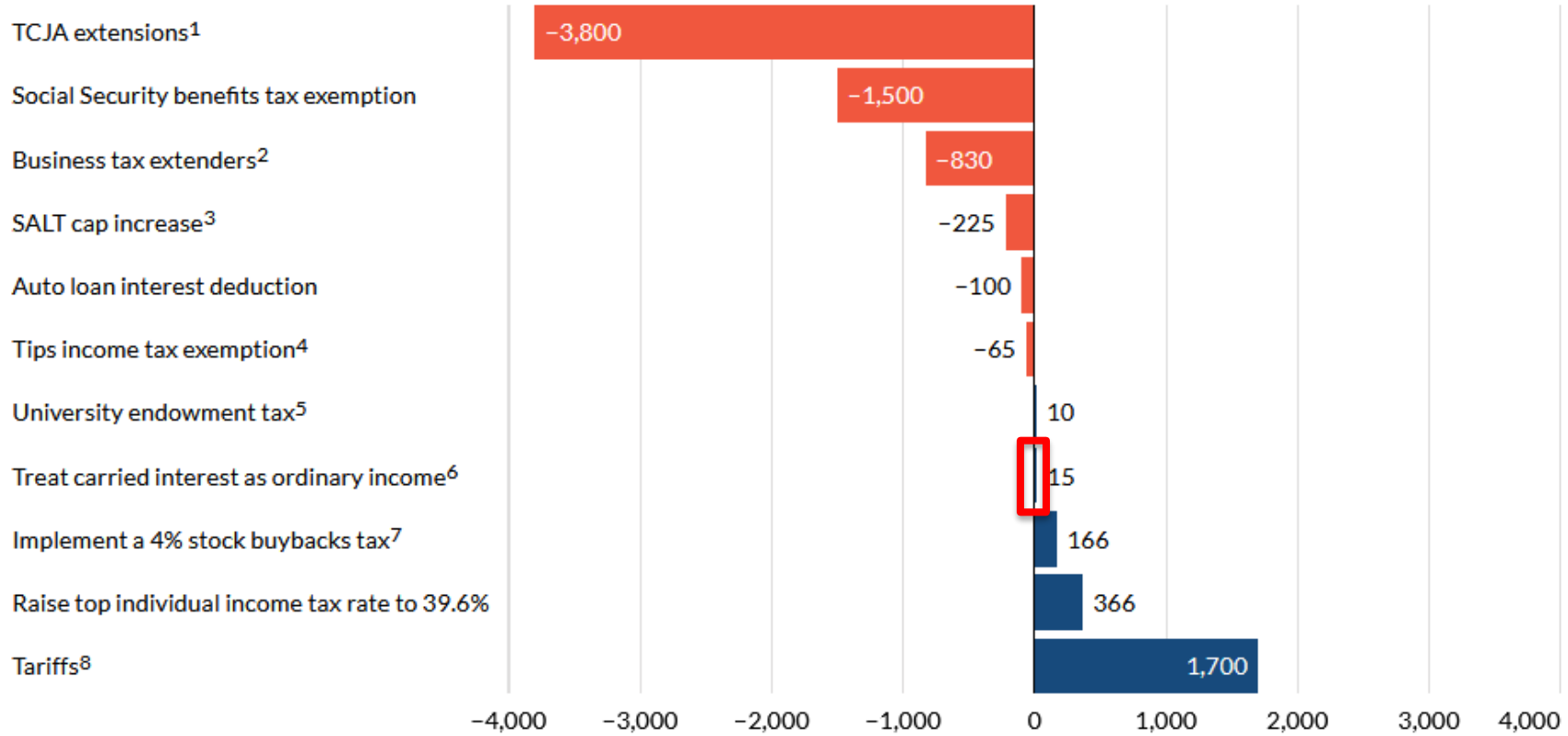
		Ordinary Income Treatment	
		Portfolio Co is C-Corp	Portfolio Co is Partnership
	Current Treatment	**Fee at Port Co.**	
	(1)	(2)	
Partner-Level Taxes			
Partner-Level Tax - Capital Gains	23.8%		
Partner-Level Tax - Ordinary Income		40.8%	
Entity-Level Tax Savings			
Portfolio Co Fee Deduction - Ordinary		-21.0%	
Fund-Level Fee Deduction - Ordinary*			
Net Tax Due	23.8%	19.8%	
Differential vs. Current		-4.0%	

Government Estimate: Ordinary Taxation

FIGURE 2

2025 Reconciliation: Selected Tax Cuts and Offsets

10-year estimated revenue change *($ billions)*



- Where's carried interest?
- Can you see it?

Brooking/Urban Institute Tax Policy Center "Big Beautiful Bill" Estimates

Conclusion

- Current treatment of carry is consistent with basic principles of the tax code, including equity and fairness
- Current treatment of carry may generate higher tax revenues for the government than alternatives
- Changing the treatment of carry may break away from basic tax principles and induce distortions in economic activity
  - Unanticipated consequences
  - Trivial, if any, revenue increase

Thank you!