

Ending the Carried Interest Loophole Act

Overview

For over a decade, Congress has debated carried interest, a favorite loophole of private equity, real estate, and hedge fund managers. This tax preference has allowed the wealthiest Americans to pay much less than their fair share for far too long.

For the first time, the Ending the Carried Interest Loophole Act closes the entire carried interest loophole—re-characterization of income from wage-like income to lower-taxed investment income and deferral of tax payments. Previously introduced bills addressed only the re-characterization of income from wage-like income to investment income.

The bill requires fund managers to recognize deemed compensation income each year and to pay annual tax on that amount, preventing them from deferring payment of taxes on wage-like income. Under the bill, a fund manager's compensation income is taxed similar to wages on an employee's W-2, subject to ordinary income rates and self-employment taxes.

What is carried interest, how is it taxed, and why should Congress act?

Carried interest ("carry," "incentive," "promote") is a form of compensation received by a fund manager in exchange for investment management services. A carried interest entitles a fund manager to future profits of a partnership, also known as a "profits interest." Under current law, a fund manager is generally not taxed when a profits interest is issued and only pays tax when income is realized by the partnership, often in connection with the sale of an investment that happens years down the road. Not only does this allow a fund manager to defer paying tax, but the eventual income from the partnership almost always takes the form of capital gain income, taxed at a preferential rate of 23.8 percent compared to the top rate of 40.8 percent for wage-like income.

The carried interest loophole is enjoyed by some of the country's wealthiest people. No one should be able to play by a different set of rules, no matter how wealthy or well-connected. With income inequality soaring, it is time for Congress to act to close this loophole for good.

What does the Ending the Carried Interest Loophole Act do?

Under the bill, a manager is required to recognize a deemed compensation amount annually, taxed at ordinary rates and subject to self-employment taxes. Analogizing a carried interest to an interest-free loan from the investors to the manager, the bill calculates a fund manager's deemed compensation amount by applying a standard rate of return to the portion of the investors' capital used to invest for the manager's own account. In other words, the deemed compensation amount is the estimated forgone interest. The fund manager realizes a long-term capital loss equivalent to the deemed compensation amount, thus preventing the transformation of compensation income into lower-taxed capital gains.

The bill leverages existing partnership tax concepts to measure deal economics between the fund manager and investors. But unlike past proposals, the bill avoids gumming up long-standing partnership rules by treating all deemed transactions as occurring between partners, on the outside of the partnership. This feature also has the effect of preventing the fund manager from deferring income, acknowledging the value of a carried interest from inception, and decoupling a manager's compensation income from fund realization and performance.