The Elusive Death of Carried Interest

Introduction

Carried interest has been at the forefront of tax reform for over fifteen years, yet it escapes practically unscathed every time legislation endeavors to close the tax loophole that harbors it. Many have tried to kill off the preferential tax treatment of carried interest, but to no avail; the most tax reformists could muster was a metaphorical maiming, which is probably an overstatement. In this article, I discuss the seemingly untouchable carried interest, its intersection with venture capital, and its contentious survival—a survival I advocate should soon come to an end.

What is Carried Interest?

Carried interest is essentially compensation for general partners of investment funds, including venture capital. This amount is seen as a performance fee and is in addition to the flat management fee these funds already charge their investors. "Carry" serves as an incentive for general partners (GPs) who are tasked with directing the fund's investment strategy: if the fund performs well, they can walk away with much more than the typical 2% management fee—an extra 20% of the investment's return *on top of* that fee.[1] The total invested capital in a fund is historically split 99:1,[2] with passively investing limited partners (LPs)[3] practically contributing all of the capital except for the small 1% that venture capitalists contribute to have some skin in

[1] DONALD J. MARPLES, CONG. RSCH. SERV., R46447, TAXATION OF CARRIED INTEREST, 2 (2022).
[2] BRAD FELD & JASON MENDELSON, VENTURE DEALS 174 (4th ed. 2019).
[3] LPs are investors, both individuals and entities, in a venture capital fund. Unlike the GPs, LPs' liability is limited to the amount of which they have invested in the fund and does not extend to their other assets.

the game. If GPs were not already working hard to see their 1% of the total invested capital return, the prospect of an additional 20% of the total return is definitely enticing.

Carried interest is only obtainable if the fund returns, upon exit,[4] all that was invested in a particular project; basically, everyone, both the GPs and the LPs, must get their money back before carry enters the picture.[5] Take a $100 million fund, for example. This fund, call it Example Ventures, has made a $10 million investment in a startup (Deal #1). If the fund returns two times this capital at the startup's IPO, $20 million, then the first $10 million gets returned to the investors of the fund in proportion to their respective investments, including the usual 1% invested by the fund itself, and the remaining profit ($10 million) is split 80% to the LPs and 20% to the GPs. This 80/20 split can be determined (a) on an investment-by-investment basis, with the general partners receiving their share of the profit after each individual deal in the fund's portfolio exits, or (b) on a cumulative basis, focusing on the overall gain or loss at the end of the fund's life.[6] The latter form is often accompanied by a "clawback" provision which is included in the investors' agreement, also known as the Limited Partnership Agreement (LPA), with the fund.[7] Such a provision allows LPs to "claw back" carried interest previously earned by the GPs if a next investment returns less than the total capital contributed.[8] This loss causes the GPs to have made more than their contracted 20% of the fund's overall profit at closing, thus entitling the LPs to take back the excess carried interest compensation.[9] Continuing with Example Venture, if the fund is structured on a *cumulative* basis, then the $2 million (20% of the $10

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[4] *See How do Startups "Exit" or Provide Liquidity to Investors?*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/education/capitalraising/building-blocks/exits (July 12, 2023).
[5] FELD & MENDELSON, *supra* note 2, at 172.
[6] *See* STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., PRESENT LAW & ANALYSIS RELATING TO TAX TREATMENT OF P'SHIP CARRIED INT. & RELATED ISSUES (Comm. Print 2007).
[7] *Id.* at 4-5.
[8] FELD & MENDELSON, *supra* note 2, at 174, 309.
[9] *Id.*

million profit) received by the GPs from Deal #1 could be up for grabs if the next deal in the fund's portfolio brings in a loss, affecting overall profit, and the fund subsequently closes. When Example Venture's next $10 million investment (Deal #2) only returns half of the initial capital ($5 million), and the fund closes in defeat, the LPs can require the GPs under the clawback provision to give up their carry from the prior deal and help make them whole. With this loss, Example Ventures now has a cumulative profit of $5 million ($10 million profit from Deal #1 minus $5 million loss from Deal #2) which is less than the total capital contributed ($20 million total with Deals #1 and #2) and prevents the GPs from taking their carried interest of $2 million from Deal #1.[10] If carry had been distributed on an investment-by-investment basis, the GPs would have $2 million in their pocket; on a cumulative basis, however, they are down to nothing, their $2 million carry viciously clawed back into the hands of the LPs.

General partners enjoy what is colloquially known as a "two and twenty" compensation structure which is standard in the venture capital industry.[11] The 2% fixed management fee is taxed as ordinary income, incurring an up to 37% tax rate, while the 20% carry, if the investment was held for more than three years, is taxed at the favorable capital gains rate of up to 20%—at least for now.

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[10] Clawback can still occur even if the fund closes with a cumulative profit. If Deal #2 had closed at a profit of $21 million, this puts the overall profit of the fund at $1 million ($21 million overall return minus $20 million total invested capital) which entitles the GPs to take their contracted 20% ($200,000). This is much less than the $2 million the GPs earned when the cumulative profit was $10 million after Deal #1, making the GPs "overpaid" under the LPA. Under a clawback provision, the LPs can require the GPs to give up the difference ($1.8 million) to comply with the contracted carried interest amount (20% of overall profit for a cumulative fund).
[11] Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U.L. REV. 1, 3 (2008) (Fleischer is credited with popularizing the phrase "two and twenty").

Taxation of Carried Interest

The tax treatment of carried interest is a result of various intersections within the Internal Revenue Code. As a preliminary matter, since partnerships are passthrough entities, carried interest compensation is realized and taxed on the individual partner level.[12] Satisfying the definition of "capital asset" under Section 1221(a) and, presumably, giving rise to a gain from the sale or exchange of such asset, carried interest also falls under the purview of long-term capital gain taxation.[13] Recall that long-term capital gains are taxed at a more favorable rate compared to ordinary income, allowing a partner to avoid paying a 37% ordinary income tax rate, assuming the GP is in the highest income bracket, and instead pay a maximum of a 20% long-term capital gains rate, if the investment is held for more than one year.[14] Or at least this *was* the rule for carried interest taxation. This all changed with the passing of the "Tax Cuts and Jobs Act" in 2017 (TCJA).[15] Section 1061 codifies the Act and classifies carried interest as an "applicable partnership interest" (API) that requires an extended holding period of more than three years to qualify for the capital gains tax rate.[16] The jump from the required one-year holding period to three years was Congress's way of tightening the tax "loophole" which otherwise enables carried interest to escape the (higher) ordinary income tax rate, and Congress may not be done just yet.

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[12] I.R.C. § 701.
[13] *Id.* §§ 1221(a), 1222(3).
[14] *See Id.* § 1411(c) (Beginning in 2013, the Net Investment Income Tax (NIIT) applied an additional 3.8% tax on certain investment income, including capital gains. In effect, individuals would be paying a 23.8% rate on long-term investments).
[15] Tax Cuts and Jobs Act, I.R.C. § 1061 (2017).
[16] *Id.* § 1061(c)(1).

Why is Carried Interest so Controversial?

Carried interest emerged on the national stage in 2007, and it has remained in the spotlight since then despite multiple attempts by Congress to give it the hook.[17] The 2017 passing of the TCJA has been the only legislation to touch it, yet staunch opponents argue that the only way to fix the problem of current carried interest policy is to get rid of its present tax treatment completely, not just give it a three-year lifeline. For example, Representative Bill Pascrell (NJ), who has been vying to kill off the preferential treatment of carried interest for years, recently introduced his third piece of carry-centered legislation titled the "Ending Wall Street Tax Giveaway Act."[18] This act would eliminate the carried interest tax loophole by taxing it as ordinary income; only income from money personally invested by venture capitalists would get capital gains tax treatment.[19] Will this be the finally be the law that gets rid of carried interest loophole for good? Only time will tell. The most predictable outcome is for continued debate from both sides over the tax characterization of carried interest, with each argument discussed below.

Arguments for Current Taxation of Carried Interest

Proponents of the existing carried interest tax regime argue that it serves as an incentive for partners in venture capital to invest in long-term, risky endeavors and remain in the venture space. By retaining VCs with the enticement of that 20% only being taxed at the long-term capital gains rate, carried interest helps drive innovation and the startup ecosystem, providing as

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[17] Becky Sullivan, *A Tax Loophole Made Fund Managers Rich*, NPR (Aug. 3, 2022, 5:00 AM), https://www.npr.org/2022/08/03/1115218183/carried-interest-close-tax-loophole.
[18] *See* Press Release, Bill Pascrell, Pascrell Unveils Ending Wall Street Tax Giveaway Act (April 18, 2023), https://pascrell.house.gov/news/documentsingle.aspx?DocumentID=5334#:~:text=The%20Ending%20Wall%20Street%20Tax%20Giveaway%20Act%20would%20close%20this,income%20subject%20to%20employment%20taxes.
[19] *See Id.*

much opportunity as available to entrepreneurs to gain funding.[20] Supporters argue that the purpose of capital gains tax treatment is to "reward entrepreneurial risk-taking and investment," providing an incentive for GPs to direct financing to more startups through their funds; taxing carried interest as ordinary income goes against this purpose and creates tension between the interests of those who have the opportunity to enter the market and those who have the power to fund that entrance.[21] Additionally, in a 2021 report, the U.S. Chamber of Commerce presented data that showed a potential loss of 4.9 million jobs across the nation and $96 billion in tax revenue with the closing of the tax loophole.[22] This loss would be due to the estimated 19.55% downsizing of the investment industry, including private equity and real estate, that will result from tax increases realized at the partnership level.[23]

Venture capital is defined by its risky investments—that is how it got its name, after all. Advocates for capital gains treatment of carried interest argue that its elimination will strike venture capital at its core: there will be no incentive in making those long-term, chancy investments that make the startup world go 'round. The same investments that led to giants like Amazon and Google,[24] life-saving medicine from Moderna and BioNTech,[25] and so much more would be stifled by the GP's tax increase. Innovation would be subdued, and jobs would be lost. Treating carried interest as a capital investment, they claim, keeps the venture world spinning on its axis and, with it, the economy.

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[20] *See generally* CHARLES SWENSON, U.S. CHAMBER OF COM. CENTER FOR CAP. MKTS. COMPETITIVENESS IMPACT ON JOBS, TAX REVENUE, AND ECON. GROWTH OF PROPOSED TAX INCREASE ON CARRIED INT. (2021).
[21] *Id.* at 6.
[22] *Id.* at 7.
[23] SWENSON, *supra* note 20.
[24] *See* Laiba Immad, *25 Largest VC Backed Companies in the US in 2023*, YAHOO! FINANCE (April 30, 2023), https://finance.yahoo.com/news/25-largest-vc-backed-companies-192418545.html.
[25] *See, e.g.,* Chris Edwards, *The Triumph of Biotechnology and Private Capital*, CATO INSTITUTE (Sept. 24, 2021), https://www.cato.org/commentary/triumph-biotechnology-private-capital.

Arguments for Reforming Taxation of Carried Interest

Advocates for the elimination of the carried interest loophole focus on the economic principles of efficiency and equity to support their argument, in addition to pointing to reports stating a tax revenue of $14 billion would be raised with the loophole's closing.[26] Tax systems are generally deemed to be more efficient when like is taxed as like, meaning similar activities receive similar taxation.[27] Carried interest is believed to be the antithesis of this; rather than being taxed as ordinary income like other forms of compensation, carried interest catches a break and makes off with a lower capital gains rate. This mismatch taxation creates "distortions" in the economy which can influence a misallocation of resources, exacerbating the inefficiency.[28] Rather than capital being efficiently allocated towards the most productive investments, it is instead tied up in projects, even those that initially seem unprofitable, for the minimum three-year period to get capital gains treatment.[29] The carried interest loophole also affects the horizontal and vertical equity in the tax system. Horizontal equity asserts that taxpayers with equal income should pay equal tax; vertical equity asserts that the amount of taxes paid increases with total income.[30] The carried interest tax regime flies in the face of both of these principles by allowing venture capitalists to pay less taxes than peers taxed at the ordinary income rate. Billionaire Warren Buffett is famously quoted for calling attention to the concerning fact that he enjoys a lower tax rate than the Berkshire Hathaway's office staff due to carried interest.[31] Seems

[26] MARPLES, *supra* note 1, at 5. *See also* Sullivan, *supra* note 17.
[27] MARPLES, *supra* note 1, at 4.
[28] AVIVA ARON-DINE, CENTER ON BUDGET AND POLICY PRIORITIES, AN ANALYSIS OF THE "CARRIED INTEREST" CONTROVERSY 1 (2007).
[29] *Id.* at 13.
[30] MARPLES, *supra* note 1, at 4.
[31] Alex Crippen, *NBC's Tom Brokaw Puts Spotlight on Warren Buffett's Call to "Tax the Rich!"* CNBC (Oct. 30, 2007, 10:21 AM), https://www.cnbc.com/id/21543506.

like a slam-dunk argument for those in favor of reform: if even Warrant Buffet is against current carried interest policy, who would reasonably be for it?

Reformists claim to not be opponents of venture capital—they just believe that VCs should be taxed like everyone else. Relying on Section 83 in the Internal Revenue Code, they insist that carried interest, as compensation for the performance of partners' services, should be taxed as ordinary income.[32] Plain and simple. Not only would taxing carried interest as ordinary income, as opposed to capital gains, be congruent with Section 83, reformists argue that it would also be in line with economic principles of efficiency and equity. Why, after all, should some of the country's wealthiest be entitled to a tax policy that is unfair to the rest of us? Supporters of the existing characterization of carried interest will claim that it is proper compensation for the partners' "sweat equity."[33] Reformists, even those who are financially benefitting from current policy, will simply call B.S.

Conclusion

However elusive, the death of the carried interest loophole is needed: the existing tax policy should be reformed. Keeping in line with the economic principles of efficiency and equity, carried interest should be taxed like all other compensation at the ordinary income rate. There is some validity in allowing general partners to realize capital gains on the amount they personally invested, typically only 1% of the fund's total invested capital; this amount should be easy to determine and separate from the rest of the carry I argue should be recharacterized as ordinary income. The argument that a heavier tax on carried interest will suppress innovation and dampen the startup ecosystem is short-sighted. Eliminating the preferential tax treatment may cause some

[32] I.R.C. § 83(a)
[33] MARPLES, *supra* note 1, at 6.

temporary changes in the venture world, such as management fees slightly increasing or number of investments slightly decreasing, but those changes would not mean the elimination of venture capital itself. The simple truth is this: the economy needs startups because it needs innovation to thrive. Just because the GPs would have to shell out more in taxes, money they arguably should have been paying anyways, it would not mean the disappearance of entrepreneurs and big ideas. Venture capital is all about risky investments because those mean big payoffs. Since those risks are not going away, neither are VCs because they will not make the same thrill-inducing return anywhere else. The market needs investment funds—the long, overdue death of the carried interest loophole will not be the death of them.