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# Close the carried interest loophole that is a tax dodge for super-rich private equity executives

The carried interest tax loophole is an income tax avoidance scheme that allows private equity and hedge fund executives — some of the richest people in the world — to substantially lower the amount they pay in taxes. The carried interest loophole allows private equity barons to claim large parts of their compensation for services as investment gains, which allows them to pay lower tax rates than middle class taxpayers pay on their wages and other compensation. The loophole exacerbates income and wealth inequality. Treating carried interest income as ordinary compensation income could raise between $1.4 billion and $18 billion annually. A significant majority of voters across parties support legislation that would close this loophole.

## "Carried interest" disguises compensation income as capital gains, lowering the tax rate

Carried interest is effectively a payment for investment services that is taken out of the profits of the money managed for investors. Private equity firms use pooled money from large institutional investors like pension funds to purchase companies or financial stakes in companies. The investors pay the private equity firms carried interest out of their investment profits. Under current tax law, the carried interest income is taxed at the preferential rates granted to investment income, even though the income represents compensation for services. In all other contexts, compensation income is taxed as ordinary income. The carried interest tax loophole is tax alchemy that magically turns ordinary compensation income into preferentially taxed investment income.

The term "carried interest" can be traced back to the 16th century, when trans-oceanic ship captains would frequently take a 20 percent "interest" of whatever profits were realized from the cargo they "carried" (largely extractive profits from the colonies).[1]

Today, this carried interest is captured by extractive Wall Street private investment houses including private equity funds, hedge funds, and venture capital funds, which are organized as partnerships.

Private fund managers typically charge investors two main fees for providing investment management services. One is an annual management fee of 2 percent of investment capital, while the other is a carried interest of approximately 20 percent of the fund's investment returns. Private equity firms generally charge carried interest fees only to the extent the investment returns exceed a "performance hurdle" (usually a rate of return of 6 to 8 percent), while venture capital funds and hedge funds generally do not impose such a hurdle.

## Carried interest is taxed at a lower rate than ordinary income—less than the tax rate nurses and teachers pay

Under current tax law, the carried interest paid to fund managers is taxed as if it were a profit from a long-term investment rather than what it is: compensation for performing services (managing other people's money). This distinction allows the general partners to almost halve their tax bill by paying the 20 percent long-term capital gains rate instead of the ordinary income tax rate of 37 percent that would likely apply to these top earners.

This 20 percent long-term capital gain rate is lower than the marginal tax rate applied to most families — in 2021, single filers would pay a marginal tax rate of 22 percent of their taxable income if they earn over $40,525 ($81,051 for married couples filing jointly). This means that private equity managers pay a lower marginal tax rate on the carried interest income than most nurses, teachers, and firefighters pay on their salaries.

## Carried interest loophole cuts tax bill in half for private equity barons

A private equity firm takes over a company in a leveraged buyout, holds it for 5 years, and sells it at a profit (the sale price less the initial investment stake). The private equity firm takes 20 percent of all limited partners' profits above the 8 percent hurdle rate. That carried interest payment is a management fee that is income for services *not* investment income and should be taxed as regular income.

For example, a private equity firm (PiratePartners) and its limited partner pension investors (WorkersPension) takeover WidgetCo in a $100 million leveraged buyout. The acquisition is 60 percent leveraged (meaning WidgetCo took out $60 million in debt to finance its own takeover) and the firm and its limited partners invest $40 million in equity (typically 2 percent is the private equity firm's own investment and the rest is the limited partners equity stake). PiratePartners invests $2 million and WorkersPension puts in the other $38 million for a $40 million investment.

Five years later, PiratePartners sells WidgetCo for $140 million. The $60 million debt stays with WidgetCo and the PiratePartners and WorkersPension capture a $100 million gain on their $40 million investment. WorkersPension made 95 percent of the equity investment and (before carried interest) would receive $95 million of the gain. But because of the carried interest, $10.8 million of that gain (calculated after the 8 percent hurdle) would instead be allocated to PiratePartners.

PiratePartners managers would pay $2.2 million in federal income taxes on its carried interest — far less than the $4 million they would pay if these earnings were appropriately taxed as ordinary compensation income. The carried interest fee income is in *addition* to the return on their own equity investment; that income, unlike carried interest, is appropriately taxed as investment income.

**Table 1: Carried Interest Collected by Five Large Private Equity Firms**
(dollars in millions)

| Firm | 2020 | 2019 | 2018 | 3-Year Total |
|---|---|---|---|---|
| KKR | $1,719.5 | $2,041.8 | $441.5 | $4,202.9 |
| Apollo | $310.5 | $1,057.1 | $(400.3) | $967.3 |
| Blackstone | $2,106.0 | $1,739.0 | $1,876.5 | $5,721.5 |
| Carlyle | $1,635.9 | $799.1 | $622.9 | $3,057.9 |
| Ares | $505.6 | $621.8 | $42.4 | $1,169.9 |
| 5-Firm Total | $6,277.5 | $6,258.9 | $2,583.0 | $15,119.5 |

Source: SEC 10-K filings

## Private equity barons, not investors, benefit from carried interest loophole

The carried tax loophole doesn't benefit investors, like pension funds or university endowments — in fact, investors effectively pay the carried interest to the fund managers. For example, the California Public Employees' Retirement System (CalPERS), the largest U.S. public pension fund, disclosed paying a total $3.4 billion in carried interest to the private equity firms that managed the pension fund investments from 1990 to 2015. That is $3.4 billion siphoned away from pensioners and into the coffers of some of the wealthiest Wall Street investment managers. (During the same period CalPERS received $24.2 billion in net profits from its private equity investments.)[2]

University endowments, including Yale, Harvard, the University of Texas, Stanford and Princeton, have paid fund managers more in carried interest arrangements than they have dedicated to tuition assistance for students. For example, in 2014 alone, Yale University paid its private equity managers $343 million just in carried interest fees while earmarking $170 million in the university's budget for student financial assistance.[3]

## Carried interest is a private equity tax break giveaway

Carried interest is a tax break that overwhelmingly benefits the private equity industry. Private equity is a $4.5 trillion industry known for using mountains of debt to take over companies in leveraged buyouts and then extract as much value as

**Table 2. Selected Private Equity Executives 2020 Carried Interest and Net-Worth**

| Executive | Firm (Position) | 2020 Carried interest (millions) | Net Worth in 2021 (billions) |
|---|---|---|---|
| Henry R. Kravis | KKR (co-CEO) | $41.25 | $7.3 |
| George R. Roberts | KKR (co-CEO) | $41.25 | $7.6 |
| Stephen Schwarzman | Blackstone (CEO) | $78.44 | $21.9 |
| Jonathan Gray | Blackstone (COO) | $71.81 | $4.5 |
| Source: SEC 2020 filings; Forbes World's Billionaires 2021 | | | |

possible before selling them again or taking them public. The general opacity of the private equity industry makes it almost impossible to determine the total tax benefit it reaps from the loophole or the exact number of executives who claim it. But five large and publicly traded private equity firms disclosed $6.3 billion in carried interest revenue in 2020 in their SEC filings. In the last three years, these five private equity firms combined have received $15.1 billion in carried interest revenue (see Table 1).[4]

## Private equity executives are the biggest beneficiaries of carried interest loophole

Most of the carried interest income passes through the private equity firms to a relatively small number of individuals. It allows them to take modest salaries (which are taxed at the ordinary income rate) and take their primary compensation in the form of the lower-taxed performance fee of carried interest. In 2020, the top four KKR executives each grabbed a combined $154 million payment of carried interest (see Table 2). From 2018 to 2020, these four KKR executives together have received close to half a billion dollars of carried interest ($439 million).[5]

The carried interest loophole enabled these KKR executives to convert the vast majority of their income into investment income and not ordinary income for tax purposes, generating massive payouts. If the $154 million had been taxed as ordinary income at 37 percent, the after-tax earnings would have been $97 million. But the carried interest loophole allows them to take home $123 million after taxes—a $26 million income boost for just 4 executives.

The private equity industry spends almost $120 billion a year in executive compensation,[6] mostly under the "2 and 20" structure that allows them to pay lower marginal tax rates than teachers or nurses pay on their salary and wages.

## Trump's 2017 tax giveaway kept the carried interest loophole alive

As a candidate Trump promised to close the carried interest loophole, saying that investment fund managers were "'getting away with murder' by not paying their fair share of taxes," according to the *New York Times*.[7] But when the time came to change the tax law, the administration and the Republican Congress sided with private equity lobbyists to preserve the carried interest loophole in the 2017 Tax Cuts and Jobs Act. The tax law claimed to fix the carried interest loophole but the provisions were easy to circumvent. It required investments to be held for a minimum of three years to qualify for the tax break, but virtually all private equity investments are held for 5 to 7 years meaning they would all qualify for the tax giveaway.

Clever accounting techniques can even dodge the 3-year requirement. Executives can use "carry waivers" to effectively move gains from investments sold within three years to other investments that will be disposed after the minimum holding period,[8] making the three-year holding period almost irrelevant for the industry. The failure of the 2017 tax law to close the carried interest loophole has been called "a home run for private equity investors."[9]

## Private equity deploying lobbyists to save preferential tax treatment

Closing the carried interest tax loophole was part of the Democratic Party platform in 2020 and was included in the set of recommendations by the Unity Task Force of the Biden and Sanders presidential campaigns.[10] As the Biden administration proposes closing corporate tax breaks and loopholes including the carried interest loophole,[11] individual private equity firms and the major trade group representing their industry, the American Investment Council, are investing in top tier lobbying talent to save their preferential tax treatment.[12]

| Table 3. Tax Difference between $1 million management fee vs fee waiver | Management Fee | Fee Waiver |
|---|---|---|
| Income amount | $1,000,000 | $1,000,000 |
| Applicable tax rate | 37% | 20% |
| Tax amount owed | $370,000 | $200,000 |
| Difference (tax benefit) | | $170,000 |

The private equity industry has spent over $25 million in lobbying since 2020, according to data from the Center for Responsive Politics,[13] and more than half a billion (nearly $600 million) in campaign contributions over the last ten years.[14]

## Significant majority of the public favors closing the carried interest loophole

Voters across party lines recognize the problem with this inequitable tax break. More than three-quarters of voters (77 percent) support legislation that would eliminate tax loopholes abused by private equity executives, often making eight to nine figure-incomes, to pay less than their fair share of taxes.[15] The Carried Interest Fairness Act of 2021 would close the carried interest loophole and raise billions in tax revenue. Treating carried interest earnings as ordinary compensation income could raise between $1.4 billion and $18 billion annually.[16] Senator Ron Wyden's 2021 proposal to close the carried interest loophole is projected to raise $6.3 billion annually.[17]

## Private Equity fee-waivers converts regular income into carried interest

Private equity firms have developed other schemes to further exploit the lucrative distinction between the capital gains and the ordinary income tax rates. One widely used device involves a purported waiver of the 2 percent annual management fee in exchange for an equivalent cut of potential investment profits. If successful, these fee waivers allow fund managers to pay low capital gains rates on even the fixed portion of their compensation income. Table 3 illustrates the tax benefits of waiving $1 million in management fees.[18]

Tax lawyers have referred to this tax-avoidance trick as the "holy grail."[19] In one startling example, Bain Capital's management fee waivers turned about $1 billion in management fees that would have been taxed as ordinary income into fund profits taxed as capital gains, saving its partners roughly $200 million in income taxes.[20]

## Endnotes

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3 Fleischer, Victor. "Stop Universities From Hoarding Money." *New York Times.* August 19, 2015.
4 AFR analysis of each company's SEC disclosures. Annual Report, Form 10-K, for years ended in December 31, 2018, 2019, and 2020.
5 AFR analysis of KKR SEC disclosures. See "Summary Compensation Table." Form 10-K. Fiscal years ending in December 31, 2018, 2019, and 2020, at 266, 247, 226, and 261, respectively.
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