

The Tax Treatment of Carried Interest

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Executive Summary

Congress is considering proposals to increase the taxation of “carried interest” - an integral feature of the financial arrangements of partnerships. Taxing carried interest is not a matter of fairness or closing loopholes. Increasing taxes on carried interest would constitute a potentially large tax increase on partnerships – especially in finance, insurance, and real estate – both in dollar terms and relative to the income generation of the affected partners. The specter of these tax implications will spawn reactions ranging from legal restructuring to crowding out valuable real economic transactions that are not sufficiently profitable to carry the additional burden. Perhaps most damaging, the higher taxes on carried interest will re-allocate managerial talent, as the entrepreneurially-inclined are deterred by these higher taxes and seek their outlets elsewhere in the economy. The proposed tax treatment is inconsistent with basic principles of tax policy.

Introduction

Congress is considering proposals to increase the taxation of “carried interest.” Carried interest is an integral feature of the financial arrangements of partnerships, a management structure broadly utilized in the United States and especially prominent in finance, insurance, and commercial real estate. This structure provides the general partners with a share of profits that is more than proportional to their capital contribution only if those general partners are successful in achieving the investment goals of the partnership. The business model permits entrepreneurs to match their expertise with a financial partner, assume risks, and align the parties’ economic interests so that entrepreneurial risk taking is viable.

While tax increases are almost never desirable per se, this initiative occurs at a time when the financial sector is recovering from a severe crisis, real economic activity remains well below potential, and financial market volatility continues. In these circumstances, it would seem desirable to only enact those tax changes that had indisputable efficiency and equity improvements.

This paper examines the impact of changing the tax treatment of carried interest.¹ It begins by reviewing the current tax treatment and the proposed changes to carried interest tax policy. Next, we turn to the extent and scale of partnership operations, and the range of impacts that higher taxes might deliver and follow this with analysis of the likely channels by which raising taxes on carried interest would affect the United States. The final section is a summary.

To anticipate the conclusions, increasing taxes on carried interest would constitute a potentially large tax increase on partnerships – especially in finance, insurance, and real estate – both in dollar terms and relative to the income generation of the affected partners. The specter of these tax implications will spawn reactions ranging from legal restructuring to crowding out valuable real economic transactions that are not sufficiently profitable to carry the additional burden. Perhaps most damaging, the higher taxes on carried interest will re-allocate managerial talent, as the entrepreneurially-inclined are deterred by these higher taxes and seek their outlets elsewhere in the economy.

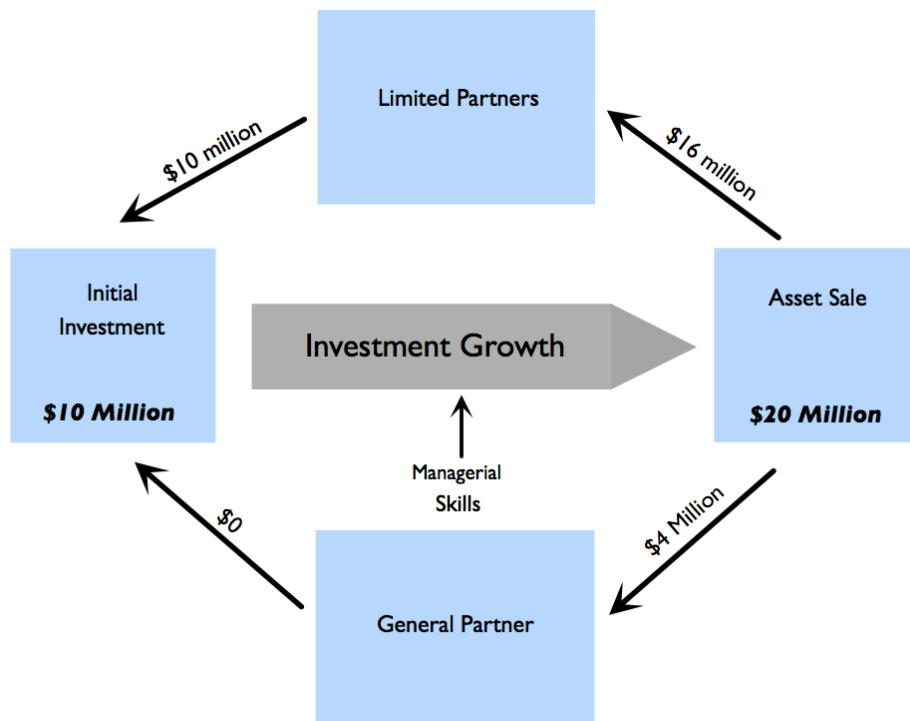
The Tax Proposal

Many business ventures are organized as limited partnerships. Investors such as pension funds, endowments, foundations, individuals, and others contribute capital and become limited partners (LP) in the partnerships. One or more general partners (GP) provide entrepreneurial management of the partnership and are paid a management fee that is typically one to two percent of the overall partnership’s capital.

In a typical partnership, the GP also contributes capital alongside the investors’ capital. This ranges from 1-10 percent in most cases. The GP also receives an interest in the overall profits above the share allocable to his capital contribution. This interest is commonly referred to as a “promote,” “profits interest,” or “carried interest.” Typically, the carried interest is 20 percent of the profits and is generated from appreciation in the value of the partnership’s property. In the case of real estate, for example,

¹This paper draws heavily from Holtz-Eakin, Douglas (2007) Commercial Real Estate and Changing the Tax Treatment of Carried Interest.

Cash and Entrepreneurial Contributions: Where Does Carried Interest Come From?



The initial investment is provided by limited partners -- in this example \$10 million. The general partner invests no capital, but contributes entrepreneurial management to meet growth objectives. At sale, the general partner gets his or her share, usually 20 percent, and the rest is return on investment for the limited partners. The carried interest is the \$4 million provided to the general partner.

this means that after a period of between five to 10 years, the GP receives a payoff linked to the degree to which the entrepreneurial input has resulted in higher asset prices.

The carried interest provides powerful incentives to align the interests of the GP and the LPs. While the GP also receives a management fee that covers administrative overhead, operating costs, and managers’ salaries, that fee is fixed and does not provide incentives to improve the performance of the real assets.

The management fees are taxed as ordinary income. The carried interest, however, is taxed at the time of sale. The tax character of the income is consistent with that distributed by the partnership. The sale of the partnership’s real assets produces a long-term capital gain taxable at the capital gain rates (maximum 15 percent).

Proposals to change the taxation of carried interest have been proposed and passed by the House, but have yet to pass the Senate. The

proposed bill would take effect on January 1, 2011. For the first two years 50 percent of such income is taxed as ordinary income at the 39.6 percent rate and the remainder at the 20 percent capital gains rate. Beginning on January 1, 2013 and thereafter, 75 percent of such income is taxed at the ordinary income rate of 39.6 percent and 25 percent is taxed at the 20 percent capital gains rate.

Principles of Taxation and Carried Interest

Proponents of this change argue that the current tax treatment is “unfair” because it accords a particular form of GP compensation preferential tax treatment. They argue that the GP is providing services to the partnership and services are taxable as ordinary income.

How does this assertion compare to standard principles of tax policy? From an equity perspective, a greater unfairness inherent in the proposal is that it would cause similar taxpayers

to be taxed differently. If enacted, investments in real assets would face different effective tax rates depending upon whether they are undertaken by an individual, C Corporation, or via the limited partnership structure.

Next, carried interest is not the same as other compensation. The carried interest is a *potential* share of partnership profits and not considered compensation for services by the partners – management and other annual fees constitute such compensation. These not insubstantial fees are taxed at ordinary income rates. They are based on the entire amount of partnership capital under management and paid annually by the partnership. The management fee is typically 2 percent of capital under management but can also include other fees like acquisition, development and leasing fees. If a partnership under-performs, they are the only income the general partner receives. Simply stating that the carried interest is compensation for services ignores the economic relationship of the partners in the partnership.

The tax change is potentially unfair from a third perspective as current proposals are not exclusively changes in the prospective treatment of carried interest. That is, they do not rule out retroactive tax increases on investments undertaken assuming that carried interests would be characterized as capital gains for tax purposes.

From an efficiency perspective, treating carried interest as ordinary income would not improve the U.S. tax code. First, differential taxation of capital income across sectors and business forms introduces inefficiencies in the allocation of national wealth.

Second, the proposed treatment is inconsistent with both income tax principles and

consumption tax principles. Consider the latter. There is now a wide consensus that fiscal policy in the United States must promote the most sustainable pace of long-term economic growth. As part of this, it is essential to keep taxes on the return to saving, investment, and entrepreneurial innovation as low as possible. Pro-growth tax reforms that focus on taxing consumption typically permit a full deduction from the tax base for all capital contributions to investments as the appropriate offset for taxing the future cash flow returns at a full rate. The proposed tax change on carried interest imposes the latter taxation, without the corresponding deduction and is, thus, inconsistent with a consumption tax base.

Similarly, it is inconsistent with a Haig-Simons income tax in which the appropriate base is the potential to consume during the tax year – i.e., the actual consumption plus any net saving. Under an income tax, the GP should be taxed on the basis of the expected increase in consumption in the year in which the project is begun.

In sum, from the perspective of tax policy, it is neither a genuine move toward more fairness in the current tax system nor a movement of the current system toward a more desirable overall tax code.

Impacts of Changing the Tax Treatment of Carried Interest

A straightforward approach to analyzing the impact of changing the tax treatment of carried interest begins noting that partnerships are a pervasive part of the economic landscape. Table 1 displays selected characteristics of partnerships using data for 2007 drawn from the Internal Revenue Service's *Statistics of Income* data series.

The data indicate that there were roughly 3.1 million partnerships comprising over 18 million partners. These enterprises managed over \$21.4 trillion dollars (in 2010 dollars) in assets and generated net income of roughly \$718 billion. Clearly, substantially increasing the taxes on such a broad-based business structure will have potentially dramatic impacts on the economy.

Counted by number, partnerships are most prominent in real estate (47 percent), finance and insurance (10 percent) and retail trade (5 percent). Viewed from the perspective of total assets, the finance sector (57 percent) appears larger than real estate (20 percent).

Table 2 draws on the information in Table 1 and focuses attention on the potential magnitudes involved in changing the tax treatment of carried interests, with particular emphasis on the finance, insurance and real estate industries.² Specifically, consider the first column that shows the economy-wide partnerships. It indicates that of the \$1.9 trillion in net income generated by partnerships, roughly \$738 billion is has the character that would potentially lead it to be classified as carried interest (the sum of “Net long-term capital gain” and “Net section 1231 gain”). To get a rough sense of magnitudes, we assume that 20 percent of this income flow is the share of general partners yields an estimate of the income that might be subject to reclassification for tax purposes – \$148 billion.

As shown in the bottom panel of the table, these data suggest that changing the tax treatment from a 15 percent tax rate to the fully-

phased in tax treatment would increase total taxes from this source from \$22 billion to \$51 billion – a tax increase of \$29 billion.³

The remaining columns indicate that a similar accounting exercise suggests that the finance industry faces a potential rise of nearly \$18.0 billion, while the real estate sector would face a \$7.6 billion increase, or nearly as large as the finance industry.⁴ Regardless of the original intentions of advocates for the change, the overall potential increased taxation of carried interest will likely have substantial economic impacts.

Table 2 offers an alternative metric of the size of the tax increase. Ideally, one would like to know what fraction of an individual general partner’s income would be subject to greater tax, and just how much higher (in absolute or percentage terms) the partner’s taxes would be. Unfortunately, general partners incomes could come from a variety of sources – multiple partnerships, wage and salary income from another job, portfolio investment income, spouses earnings, etc. – and data that are organized by partnership will not be able to shed light on this impact.

However, Table 2 does show the flow of income from partnerships to partners. Thus, for the real estate industry, approximately \$18.5 billion flowed to individual general partners. Assuming that there is a single individual general partner for each of the 1.5 million partnerships, this corresponds to about \$12,000 per GP. If there were two such general partners on average it would be only \$6,000.

²The data in Table 2 are restricted to those returns that permit the allocation of income to partners, a crucial consideration as the tax treatment of carried interests is focused on general partners.

³For this calculation we use the fully-phased-in proposal, which would take effect after the sunset of the 2001 and 2003 tax laws. Thus, the effective tax rate is $(0.75 \times 39.6) + (0.25 \times 20.0) = 34.7$ percent.

⁴Given the sharp downturn in the financial services and commercial real estate sectors, these estimates likely overstate the near-term revenue effect and are more indicative of the long-term impact.

	Table I: Characteristics of Partnerships, 2007 (Dollar values in thousands of 2010 dollars)											
	All Industries	Agriculture, forestry, fishing, and hunting	Mining	Utilities	Construction	Manufacturing	Wholesale trade	Retail trade	Transportation and warehousing	Information	Finance and Insurance	Real estate and rental and leasing
Number of partnerships	3,096,334	126,884	39,581	3,991	208,538	47,683	53,515	166,561	46,464	34,206	308,307	1,488,966
Number of partners	18,515,694	402,395	979,952	97,169	554,232	402,630	348,285	500,182	1,043,215	158,926	4,431,223	6,792,082
Total assets	21,405,440,664	150,374,705	253,553,790	170,363,860	351,615,515	627,663,341	200,036,013	137,522,519	203,677,647	615,487,077	12,877,367,074	4,571,551,514
Income and deductions from a trade or business:												
Total income	4,456,024,680	38,558,980	114,343,746	144,317,934	326,333,098	917,170,172	564,315,747	415,730,805	130,159,202	268,181,019	403,092,471	206,717,404
Business receipts	4,039,385,551	29,876,943	105,819,006	140,360,371	319,823,360	899,052,267	557,374,616	407,028,350	124,794,926	242,949,867	182,526,070	176,397,225
Ordinary income from other partnerships and fiduciaries	107,518,936	897,829	3,870,186	1,799,936	1,842,226	4,853,076	1,288,774	721,649	1,831,479	13,569,785	31,791,961	13,153,506
Farm net profit	6,350,768	6,078,731	1,513	0	1,898	1,442	0	67,743	0	0	84,237	79,637
Net gain, noncapital assets	18,451,479	870,637	1,904,094	1,061,983	484,257	1,701,250	190,959	260,148	1,275,930	484,444	5,027,753	2,689,026
Other income	284,317,946	834,840	2,748,946	1,095,645	4,181,357	11,562,137	5,461,397	7,652,915	2,256,868	11,176,921	183,662,450	14,398,010
Total deductions	4,134,990,198	38,349,257	79,755,768	139,559,632	317,718,896	862,361,040	543,895,570	413,211,720	123,385,713	236,467,869	363,105,815	203,052,404
Salaries and wages	391,687,785	2,001,477	2,656,641	1,229,990	11,185,743	26,510,555	17,692,309	29,416,926	7,242,613	25,612,841	52,338,828	15,121,471
Portfolio income (loss) distributed directly to partners	1,029,903,728	3,367,588	13,911,443	5,282,519	4,148,607	14,046,400	1,904,397	2,018,288	2,290,877	5,427,263	830,476,201	86,001,715
Interest income	272,897,597	1,457,311	2,304,832	1,479,403	1,624,036	5,345,189	742,049	549,822	680,149	3,205,115	2,143,287,735	25,078,726
Dividend income	109,949,424	154,176	436,102	37,950	116,363	4,128,766	145,554	412,312	246,869	281,863	87,363,464	7,655,309
Royalties	18,513,716	627,082	5,389,916	6,775	18,979	2,422,622	198,431	13,073	332	2,373,681	3,338,532	1,246,494
Net short-term capital gain (loss)	91,803,581	-17,393	922,709	247,845	131,901	219,037	11,262	242,369	76,073	43,365	86,952,192	2,557,461
Net long-term capital gain (loss)	536,739,411	1,146,413	4,857,884	3,510,546	2,257,329	1,930,787	807,101	800,712	1,287,454	-476,761	438,493,278	49,463,724
Net rental real estate income (loss)	-1,280,433	260,195	-34,465	1,596	-588,518	20,264	12,975	148,418	3,400	15,782	-3,328,642	3,439,079
Net income	98,486,375	438,020	22,136	1,746	221,631	25,868	22,066	197,060	59,794	28,308	1,705,222	94,801,038
Loss	99,766,808	177,824	56,601	150	810,150	5,604	9,091	48,641	56,394	12,527	5,033,864	91,361,960
Other net rental income (loss)	-3,579,012	83,516	75,945	5,618	-1,979	733,279	34,160	50,928	-129,146	-1,661,638	-2,849,222	-147,876
Net income	7,075,337	91,058	76,838	17,767	21,575	738,861	63,484	63,062	130,305	470,307	630,113	4,183,659
Loss	10,654,349	7,541	893	12,150	23,555	5,581	29,324	12,134	259,451	2,131,944	3,479,335	4,331,535
Total net income (loss) [2]	717,535,772	2,792,003	42,760,308	6,289,642	9,783,083	67,459,251	21,553,346	3,693,638	7,575,094	35,927,953	338,839,523	40,936,732
Net income	1,024,697,816	10,348,442	53,287,392	10,149,376	25,263,860	83,233,606	24,441,966	10,905,098	11,389,498	50,367,403	400,922,747	157,502,154
Loss	307,162,043	7,556,439	10,527,084	3,859,734	15,480,777	15,774,355	2,888,620	7,211,461	3,814,404	14,439,450	62,083,224	116,565,421

Table I: Characteristics of Partnerships, 2007 (Dollar values in thousands of 2010 dollars), cont.

	All Industries	Real estate	Lessors of Nonresidential buildings (except mini-warehouses)	Professional, scientific, and technical services	Management	Administrative and support and waste management and remediation services	Educational services	Health care and social assistance	Arts, entertainment, and recreation	Accommodation and food services	Other services
Number of partnerships	3,096,334	1,454,179	510,042	175,546	23,578	62,004	11,605	67,522	54,867	106,954	68,949
Number of partners	18,515,694	6,657,377	2,158,788	633,193	683,384	151,935	29,618	353,922	384,436	381,100	186,552
Total assets	21,405,440,664	4,438,015,977	1,781,911,902	194,671,465	549,632,445	49,434,851	3,831,047	108,401,061	86,993,361	231,116,104	21,110,903
Income and deductions from a trade or business:											
Total income	4,456,024,680	175,284,670	14,884,598	378,958,887	52,343,673	79,587,714	4,741,454	180,179,269	57,129,884	148,535,822	25,462,412
Business receipts	4,039,385,551	147,668,876	10,733,739	361,927,395	25,473,496	72,497,076	4,396,008	169,159,768	51,027,601	143,833,164	24,903,053
Ordinary income from other partnerships and fiduciaries	107,518,936	13,024,116	1,226,607	5,619,180	20,516,882	1,475,299	242,608	1,478,993	1,283,660	1,120,867	161,039
Farm net profit	6,350,768	79,637	6,022	0	28,175	0	0	0	0	0	7,392
Net gain, noncapital assets	18,451,479	1,830,812	674,604	138,249	1,043,725	34,572	414	174,259	190,264	796,915	122,599
Other income	284,317,946	12,681,228	2,243,626	11,274,063	5,281,395	5,580,767	102,423	9,366,248	4,628,358	2,784,876	268,330
Total deductions	4,134,990,198	176,955,840	14,758,968	297,706,179	43,327,280	76,068,762	4,656,980	159,680,903	58,603,146	149,025,337	24,891,954
Salaries and wages	391,687,785	12,807,030	1,026,774	90,335,258	4,738,446	15,982,105	994,261	45,063,670	13,552,540	25,929,537	4,082,573
Portfolio income (loss) distributed directly to partners	1,029,903,728	82,968,916	17,341,105	7,847,636	43,519,439	1,858,399	156,646	1,928,487	2,063,025	3,085,191	511,076
Interest income	272,897,597	23,617,027	6,086,178	2,411,050	10,879,506	479,403	42,942	572,248	565,860	1,005,204	143,206
Dividend income	109,949,424	7,518,021	2,136,228	601,553	7,644,092	231,560	1,778	34,469	64,759	102,203	289,479
Royalties	18,513,716	745,152	153,818	1,984,492	508,422	2,260	0	1	92,936	289,688	0
Net short-term capital gain (loss)	91,803,581	2,524,433	592,373	-3,290	342,246	33,417	500	2,964	-29,787	51,005	11,847
Net long-term capital gain (loss)	536,739,411	48,564,282	8,372,508	2,853,830	24,145,172	1,111,760	111,426	1,318,803	1,369,259	1,637,091	66,544
Net rental real estate income (loss)	-1,280,433	3,240,255	27,447,321	-309,958	-417,483	-125,910	503	-126,337	39,573	-176,958	-113,680
Net income	98,486,375	94,360,216	56,216,882	74,892	433,729	16,057	2,059	66,456	128,265	187,809	54,222
Loss	99,766,808	91,119,961	28,769,562	384,849	851,212	141,966	1,556	192,793	88,690	364,768	167,901
Other net rental income (loss)	-3,579,012	-165,153	112,590	152,907	-130,522	5,187	0	154,431	18,341	20,126	6,930
Net income	7,075,337	637,279	368,393	162,104	212,601	5,187	0	160,672	18,894	21,922	6,930
Loss	10,654,349	802,432	255,802	9,196	343,123	0	0	6,241	552	1,796	0
Total net income (loss) [2]	717,535,772	33,284,133	36,061,765	86,092,755	27,500,408	4,111,452	129,696	21,133,178	-691,793	750,749	896,391
Net income	1,024,697,816	144,901,745	65,508,581	93,453,753	39,198,276	6,994,735	738,064	27,209,590	5,806,022	10,876,270	2,593,928
Loss	307,162,043	111,617,612	29,446,816	7,360,998	11,697,867	2,883,283	608,368	6,076,412	6,497,815	10,125,520	1,697,537

Table 2: Static Implications of Changing the Taxation of Carried Interests (Dollar values in millions of 2010 dollars)			
	All Industries	Finance and Insurance	Real Estate
Number of partnerships	3,082,116	305,512	1,484,095
Number of partners	18,433,468	4,421,816	6,775,736
Total income (loss)	\$1,907,091.90	\$1,184,242.50	\$245,227.50
Ordinary business and real estate rental income	\$319,754.40	-\$3,328.50	\$7,103.25
Net long-term capital gain	\$536,739.00	\$438,492.60	\$49,463.40
Plus Net section 1231 gain	\$201,006.75	\$18,768.75	\$143,086.65
Equals Total Income at risk to higher tax	\$737,745.75	\$457,261.35	\$192,550.05
20% Equals Potential Carried Interest Basis	\$147,549.15	\$91,452.27	\$38,510.01
Total deductions	\$319,907.70	\$229,782.00	\$26,739.30
Net Income	\$1,587,183.15	\$954,460.50	\$218,488.20
Net Income Allocated to All Partners	\$1,523,760.00	\$900,529.35	\$216,638.10
Limited partners	\$1,182,855.45	\$750,058.05	\$170,801.40
Individual general partners	\$88,651.50	\$12,758.55	\$18,498.90
Partnership general partners	\$114,184.35	\$78,733.20	\$8,590.05
All other partners	\$138,068.70	\$58,979.55	\$18,747.75
Taxation of Carried Interests			
Tax on carried interests at 15% rate	\$22,132.37	\$13,717.84	\$5,776.50
Tax on carried interests at 34.7% rate	\$51,199.56	\$31,733.94	\$13,362.97
Increased tax -- carried interests of general partners	\$29,067.18	\$18,016.10	\$7,586.47
Tax Increase: % Income of Individual general partners	32.80%	141.20%	41.00%
Tax Increase: % Income of Individual & Partnership general partners	14.30%	19.70%	28.00%

An alternative metric is to examine the increased taxes as a fraction of the underlying partners' incomes. As shown at the bottom of Table 2, overall the tax increase is 32.8 percent of the individual general partners' income and 14.3 percent of combined income of individual and partnership general partners. The average tax rates are even more striking in finance and insurance, where the static implications are that over 140 percent of individual general partners' incomes would be required to match the taxes. For real estate, the rates range from 41 percent to 28 percent.

It is important to emphasize that these computations are not a "revenue estimate" because they assume no change in the underlying behavior.⁵ Given the magnitudes involved, the absence of reaction is implausible unless the law precludes the ability to adjust to the new tax environment. We turn now to the ability and nature of such responses.

The "Retroactive" Components of Higher Carried Interest

Because these estimates are built off historical data (adjusted to rough 2010 magnitudes as noted above) and assume that there is no change in partnership behavior, they serve as a rough guide to the impact of a change in the tax treatment of carried interests if those impacts are confined to existing partnerships. If, for example, the higher tax was imposed retroactively and exclusively on existing partnerships, the partnership contractual arrangements would be fixed and GPs would be

forced to absorb these increased taxes without an avenue to minimize their impacts.

Importantly, the current proposals in Congress do not rule out retroactive taxation of existing partnerships. Thus, in the absence of change in the legislation, the impact of increasing taxes on carried interests will include at least in part these considerations.

The "Prospective" Components of Higher Carried Interest

Going forward, however, there will be efforts to restructure partnerships in response to the new, higher level of taxation. Significant additional time and capital will be spent by finance, insurance, and real estate LPs and GPs in order to re-structure their investment vehicles so that the overall impact of the new tax on carried interests can be minimized or avoided altogether.

By definition, these new legal arrangements will be inferior to the original.⁶ Thus, this outlay and use of time will not improve economic performance overall, and will not contribute to the objectives of investment managers', their institutional investors (such as pension funds) and their individual clients. Indeed, if at all possible, the GPs will have the incentive to pass these higher costs to the institutional investors and individual clients, thereby reducing their received rate of return.

A related avenue of adjustment would be to replace the incentive-based carried-interests structure between GPs and their investors with non-contingent, fixed compensation arrangements. Because of the absence of performance incentives, these types of

⁵The Joint Committee on Taxation estimates the House-passed bill will raise \$18.7 billion between 2010 and 2010. See JCX-30-10 "Estimated Revenue Effects of Estimated Revenue Effects Of The Revenue Provisions Contained In H.R. 4213, The "American Jobs And Closing Tax Loopholes Act Of 2010".

⁶If they were better, they would have been adopted in the absence of the new tax.

compensation contracts will not elicit superior investment performance, with a declining return to investment as a result. Moreover, depending upon the nature of these arrangements, they may raise little revenue as the taxed compensation to the GPs will be deductible to individual and corporate investors.⁷

However, it is unlikely that legal adjustments alone will be sufficient to avoid the entire tax. If so, the real economic activity will be affected. Intuitively, placing a greater tax burden on carried interests will raise the overall tax burden on the investment. Unless the project is sufficiently profitable, it will not be possible to pay the annual operating expenses, cover depreciation of the property, meet the contractual obligations for debt-financings, pay taxes, and offer a competitive return to the equity partners in the investment.

In such circumstances, the projects that don't make the cut will be dropped – projects that likely will be in the more marginal locations or burdened with greater risk. In modern, competitive global financial markets, even small changes in margins move trillions of dollars of financial capital; the taxed partnerships would be at a clear financial disadvantage and would lose capital to other investment opportunities.

This impact – the shifting of capital from one sector of the economy to another in response to a discriminatorily higher tax – has been extensively analyzed in the context of the corporation income tax, beginning with Harberger (1966). The analogy is quite clear: the corporation income tax is a tax on the return to capital that is

received through a particular business form – the chapter C corporation. Raising taxes on carried interest is a tax on the return to capital that is received through a particular business form – the partnership. The legal setting is different, but the economics are the same.

One dimension to the “cost” of the discriminatory taxation of carried interests is that capital is shifted to less productive uses; damaging overall economic performance. The intuition is straightforward. For simplicity, imagine that there is no tax (or equal tax treatment) across all uses of capital, and all returns are equalized at a pre-tax return of 20 percent. Now, suppose that one sector (partnerships) faces a unique and higher tax – to make the example simple – of 50 percent. Immediately, the post-tax return falls to 10 percent in this sector, inferior to opportunities of 20 percent elsewhere and capital flows to those opportunities.

The process will continue until post-tax rates of return equalize and eliminate incentives for capital shift. In this example, when pre-tax returns in the taxed sector are 30 percent and those in the less-taxed sector are 15 percent, the post-tax return will be 15 percent in both. The tax, however, generates a clear cost to the economy: capital is twice as productive (30 versus 15 percent) in the taxed sector as elsewhere. By driving capital from more productive to less productive activities, the tax reduces overall productivity of capital and shrinks the economy.

The Loss of Entrepreneurial Talent

The Harberger analysis focuses exclusively on the shifting of capital. More recent research by

⁷Not all investors are taxable; e.g., pension funds so there will not be a perfect offset. At the same time, the overall dollar value of compensation will have to exceed the existing carried interest to compensate GPs for their higher level of taxation. Knoll (2007) makes this argument.

Gravelle and Kotlikoff (1989), however, suggests that this approach badly understates the detrimental impacts of higher taxes because it has too narrow a focus. Specifically, Gravelle and Kotlikoff reconsider the computations and incorporate the fact that canceling investment projects alone are not the only fallout of raising taxes. Rather, when taxes are raised they also drive away the key element of economic success – entrepreneurial talent.

More specifically, taxed (partnerships) and untaxed (real estate investment trusts, etc.) business forms are competing for the same entrepreneurial management talent and producing the same ultimate product (investment services). Common sense suggests that the imposition of the additional tax on carried interests will diminish not only the ability to attract capital, but also the same quality of managerial talent to make the capital productive in partnerships. The prospect of lower after-tax pay will lead prospective investment managers to examine other employment options in the

market. Inevitably, the lower quality management will diminish performance. Gravelle and Kotlikoff compare the efficiency cost apparent from the standard Harberger analysis with an efficiency cost that captures the loss of entrepreneurial talent. Over a wide range of assumptions about the nature of production and competition, the costs are at least 10 times as great and as much as 25 times higher.

These results suggest that the economic costs of crowding out partnerships projects plus the lower performance that comes from diminished entrepreneurial zeal will impair the economy as a whole. These economic costs represent foregone income in the economy – a loss for everyone.

Summary and Conclusion

There appears to be little merit to changing the tax treatment of carried interests. The tax would likely inflict large damage on the finance, insurance and commercial real estate sectors, diminish their entrepreneurial talent pool, and harm overall economic efficiency.

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