The Daily Dish

TCJA and Carried Interest

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Eakinomics: TCJA and Carried Interest

The Tax Cuts and Jobs Act (TCJA) is nearing the finish line, but some of its provisions have been met with confusion and, in some cases, outright misrepresentation. Among the most prominent is the tax treatment of carried interest.

Recall that carried interest is a share of profits more than proportional to the general partners' capital contribution if they meet investment goals. The appropriate tax treatment of carried interest has been debated among policy analysts for some time. It has also over time become a political football, including during the 2016 cycle when then-candidate Clinton promised to close the carried interest "loophole" and then-candidate Trump committed to making sure that hedge fund owners did not get long-term tax treatment for their short-term profits.

Let's cover the tax policy first. There is no carried interest loophole. Under current law, carried interest is not singled out for preferential treatment. Instead, it is among those items taxed as long-term capital gains at a maximum rate of 28.6 percent. Clinton and others have proposed taxing carried interest as ordinary income — at what is now a 39.6 percent top rate, which would fall to 37 percent under the TCJA. But that is not closing a loophole. That is violating the principles of income taxation.

Here is why. Under a pure income tax, the tax base is the potential to consume during the tax year. So the partner receiving carried interest has two taxable moments. The first is when the profit share is granted, where the value of the rights to future profits in principle raises the partner's ability to consume by that value. The second is when the investment is sold, when any additional increase in value is a capital gain and should be taxed as such. Accordingly, at the realization of a carried interest, the appropriate tax rate is the long-term capital gains rate — not ordinary income tax rates. (Note that if the expected profit at the time of grant is zero, the TCJA treatment is textbook right.)

The other policy issue is raising revenue, where proponents of higher taxation argue that substantial funds are available from those with a considerable ability to pay. The problem is that taxing carried interest profits at normal income rates doesn't actually raise much revenue. Although there are outlandish estimates ranging up to nearly $200 billion dollars over the next decade, the reality is that the Joint Committee on Taxation pegs the revenue at only $15.6 billion over 10 years. Even the Obama Administration put the figure at merely $17.7 billion.

So the TCJA does not violate principles of income tax in pursuit of an illusory money grab. Instead, the TCJA ensures that short-term investors don't benefit from from preferential tax rates on long-term, patient capital by extending the holding period for carried interest from 1 year to 3 years.

In terms of the politics, the Trump campaign pledge was to prevent short-term investors from availing themselves of the tax preferences available for long-term investors. Changing the holding period to 3 years would seemingly meet this requirement.