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CARRIED INTEREST LOOPHOLE BY PRIVATE EQUITY FIRMS

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Abstract

This paper focuses on how “Carried Interest” loophole is implemented by Private Equity firms. The income that is generated by PE firms, Hedge funds is taxed under long-term capital gain or loss tax which is usually 20 percent for tax payers in the highest tax bracket. The model of private equity is described to give a clear idea of how a PE firm works and how it’s fee is structured. An example for the profits made by the PE firms with numerical is looked upon in detail and how it can be filled into the Forms 8949 and 1040 is explained. The major differences between “short-term and long-term capital gains” is discussed and the reason for them being taxed at different rates is also included.

Keywords: carried interest, private equity, “short-term and long-term capital gains”

Contents

Introduction

The word carried interest is quite interesting and has a certain history to its name. It actually dates back to the 16th century, when the ships from Europe were travelling to the US. The captain of the ship was then paid a certain amount on top of his standard fee for successfully transporting the goods between two continents. The amount which he was paid is called "Carried amount", this amount is considered as a reward to the ship captain for transporting the goods without any damage. Fast forward to 21st century, this is the same principle used by managers in "Private Equity firms, Hedge Funds, Real Estate firms, and Venture Capital firms". However, there is a slight change in the wording and it is now being called as "Carried Interest". Most people call the carried interest as a tax loophole because it is taxed under long-term capital gains tax, which is lesser than the standard tax which is paid by normal employees in a company. They feel that the managers take large chunk of money and compared to what they earn and therefore should be taxed at standard tax rates. "Under Federal law, carried interest is taxed as a capital gain, rather than as personal income, enabling Hedge Fund and Private Equity executives to pay lower taxes on some of their earnings than salaried workers." However, this issue has become quite controversial in the United States during the 2016 Presidential Elections, where then President candidate Donald J. Trump stating that "Hedge Fund and Private Equity Managers are getting away with murder." His statements then created a stir in the business circles as what could potentially happen with carried interest. Almost two years have passed, and the president is yet to take a decision on that issue. Some industry experts opine that it is impossible to eliminate carried interest loophole completely because several Tax Reforms have to be made, which could take a lot of time to implement and make the bill pass by the senate.

Literature Review

(Marples, 2014) states that:

The Private Equity firms run their businesses by buying and selling out an asset. This asset could be anything like a Business, Property etc. They actually provide technical expertise into the business they are buying and restructure the business so that it could be sold on a profit basis. It further mentions that, the Private Equity firms is generally structured as two partners i) Fund Partner and ii) Limited Partners. The compensation of the fund managers is summarized as, that they get compensated in two ways. In the first one, "they invest their own capital in the funds, they share in the appreciation of fund assets". In the second one, "they charge the outside investors two kinds of annual fees: a percentage of total fund assets, and a percentage of the fund's earnings." "The latter performance fee is called carried interest and is treated as capital gains under current tax rules." According to the article, recently some "Hedge Funds and PE firms have gone public", meaning they are obliged to "file quarterly and annual financial statements and make full range of disclosures required by the Securities and Exchange Commission (SEC)."

The Tax treatment of carried interest is argued that, "the current law treatment violates the economic principle of horizontal equity. According to this point of view, fund managers provide labor to the fund the same as other workers provide to their employees. As such, the principle of horizontal equity says the fund managers and worker should be taxed similarly. One option to correct this potential issue would be to tax carried interest as ordinary income." It also mentions about a new concept called "Tax Deferral", which is linked to the timing of tax payments. According to tax deferral, the "taxpayer prefers to pay taxes in the future, rather than today because he or she can control the funds longer, use them in some other way, and benefit from the time value of money. Deferral increases in value with both the length of the deferral period and the taxpayer's marginal tax rate. Carried Interest benefits from deferral since it is only taxed when realized-as is the case with capital gains."

The paper thoroughly discusses the 113th Congress, where "Section 268 would allow enterprise value (largely from goodwill) to be taxed as capital gains income, but the tax remainder as ordinary income, while the President's Fiscal Year budget proposal in the year 2014 (FY2014) states that the Administration is committed to working with Congress to develop mechanisms to assure the proper amount of enterprise value is taxed as capital gains income." "The Tax Reform Act of 2014 would exempt carried interests derived from real estate but a portion of the remainder as ordinary income. As a result, each proposal would treat a portion of carried interest as ordinary income and the remainder as capital gains income." "According to the Joint Committee on Taxation, the provision in the Tax Reform Act of 2014 would raise $3.1 billion in revenue in the FY2014 – FY 2023 budget window, while the provision in the President's FY2014 Budget Proposal would raise $17.4

billion in revenue in the FY2014 – FY2023 budget window. Supporters of these proposals have argued that carried interest is essentially a fee for investment advisory services, and the appropriate treatment is to tax it like other ordinary income."

(Brock, 2015) states that:

"A portion of all carried interest income should be taxed as compensation." "However, what qualifies as carried interest and the portion of the income that should be taxed as compensation are not easily defined. Most tax analysts will agree that a person who manages any PE Fund and does not have any capital at risk, but is paid a percentage of profits, should be considered to have a carried interest and all their income should be taxed at ordinary rates." "However, if the person has some capital at risk, then the percentage of income attributable to labor versus investment is not clear and will be difficult to determine. The most economically sound method that most closely adheres to tax policy objectives is to tax the amount of income earned for services as ordinary income and the amount from an investment as capital gain."

The paper largely argues about the treatment of "Long-Term capital gain as compensation" and mentions the "reasons for why the long-term capital gain income allocated to "carried interest holders should be treated as compensation" (which is "taxed as ordinary income at 35 percent") "instead of as long-term capital gain". The first reason is that, if the capital, which is initially invested in the fund has no exposure to risk, then it "should be taxed at ordinary rates." It also further argues that, the "carried interest holder is receiving 20 percent of the future profits even though the holder made no capital contribution". Thus, the "carried interest holder is actually receiving 20 percent for his services to the partnership and not in return for his capital investment." The second reason is that the PE fund managers are performing a service with the capital in hand. "In these situations, the private equity fund managers is responsible for making investment decisions and managing those investments for the partnership. Thus, the managers are working for the partnership in a manner similar to CEOs and other managers of a corporation."

The fairness in the article argues that the taxpayers be treated similarly. It points out that "whether it is fair for holders of carried interest who have not invested any capital into a business to be taxed at long-term capital gains when the average citizen who goes to work for a wage (and, similarly does not invest any capital into a business) is taxed as ordinary income rates. In this regard, it is crucial to note that but for the existence of the partnership, the carried interest holder would receive payment directly from the investors in exchange for managing their capital and that income would undoubtedly be ordinary income.” The paper also discussed the negative side of charging long-term capital gains as compensation and mentions that 1) “changing the tax treatment would damage the private equity market, 2) changing the tax treatment would hurt the ordinary investor, and 3) changing the tax treatment would lead to U.S. firms moving overseas. However, none of the above arguments can be supported by good tax policy.”

“The bill introduced in the House of Representatives in 2007 (H.R. 2834, June 22) would have added Section 710 to the Internal Revenue Code. It would have taxed any Investment Services Partnership Interest (ISPI) at ordinary rates. The definition of an ISPI under this bill was far-reaching and would have affected many different types of partnerships. The effect of this provision went so far beyond the typical definition of a carried interest that many groups, including the American Institute of Certified Public Accountants (AICPA) and the American Bar Association (ABA), wrote comment letters opposing the implementation” (Brock, 2015)

“What portion of the Income earned through carried interest should be taxed as ordinary income is discussed by providing a proposal in the 2007 Act which would tax all income, including the gain or loss on the sale of the interest as ordinary. However, most policymakers agree that only the income earned from labor should be taxed as compensation, while the income earned on the capital should be taxed as investment income. In reality, the income earned by the carried interest is a combination of compensation for services and a return on a capital investment and should be taxed to reflect that dual nature. The issue that has not been answered is how to separate the income between labor and capital. One method would be to tax income earned annually at ordinary rates as compensation and to tax the gain on the sale of the carried interest as a capital gain. However, that simplified answer does not clearly reflect the actual amount earned for services and the return on any capital. In the 2010 bill that the House of Representatives passed, 50 percent of the income allocated to an ISPI would be taxed as ordinary compensation for two years and 75 percent in subsequent years. Again, these percentages are amounts agreed upon by congress, but do not reflect the actual amount earned for services versus a return on capital. A set percentage such as that included in the House bill is simpler to implement, but does not reflect the economics and also does not take into consideration the different types of partnerships that have carried interests. Another method that has been proposed is to treat the carried interest as if the capital were temporarily borrowed from the limited partners. In this scenario, the holder of the carried interest would be treated as if he borrowed a percentage (generally, 20 percent) of the total capital invested in the fund for the life of the fund. In this case, ordinary income would be imputed to the manager based on the amount of interest that would have been paid under normal lending circumstances. The imputed income would be taxed as ordinary income. In addition, the ordinary income that the partner recognizes would increase his basis in his partnership interest to prevent any double taxation. Any gain or loss on the sale of his partnership interest would be capital in nature."

(Wanroy, 2017) states that:

"The proposed legislation by several of the states to close the perceived carried interest loophole is an attempt to generate additional revenue. In addition, some opponents of the legislation view it as a political tactic to ingratiate the constituency frustrated by the belief that the wealthy investment managers are not paying their fair share and operate under a different set of tax rules. As of the date of this column, none of the proposal shave been enacted into law, and it is uncertain if first, there is the political will to get these bills passed, and second, even if passed, would any of the proposed bills survive legal challenge? In addition, one must wonder, if passed, would the legislation produce the projected revenue? In a mobile world, where one simply needs a smart phone, laptop, and an Internet connection to conduct business, would investment managers simply move out of jurisdictions imposing such seemingly punitive tax rules on an investment manager? Lastly, with the prospects of tax reform looming on the horizon, will the carried interest "loophole" be addressed as part of overall tax reform? President Trump during his Presidential campaign appeared to strongly support the closing of the carried interest loophole."

It looks into the latest carried interest tax proposals which was latest introduced at the beginning of May by Representative Sander Levin, "The Carried Interest Fairness Act of 2017", which "would tax carried interests at ordinary income rates, the issue remains unsettled. Several states have proposed a tax on investment management service income ranging from 19 percent to 24 percent, rationalizing that the additional tax will compensate for the perceived inequity fund managers receive by being taxed at the generous lower capital gains tax rates on their carried interest, which many believe should be taxed as ordinary income rates. If the proposed legislation is passed, it would have a significant impact on the investment community (Wanroy, 2017)."

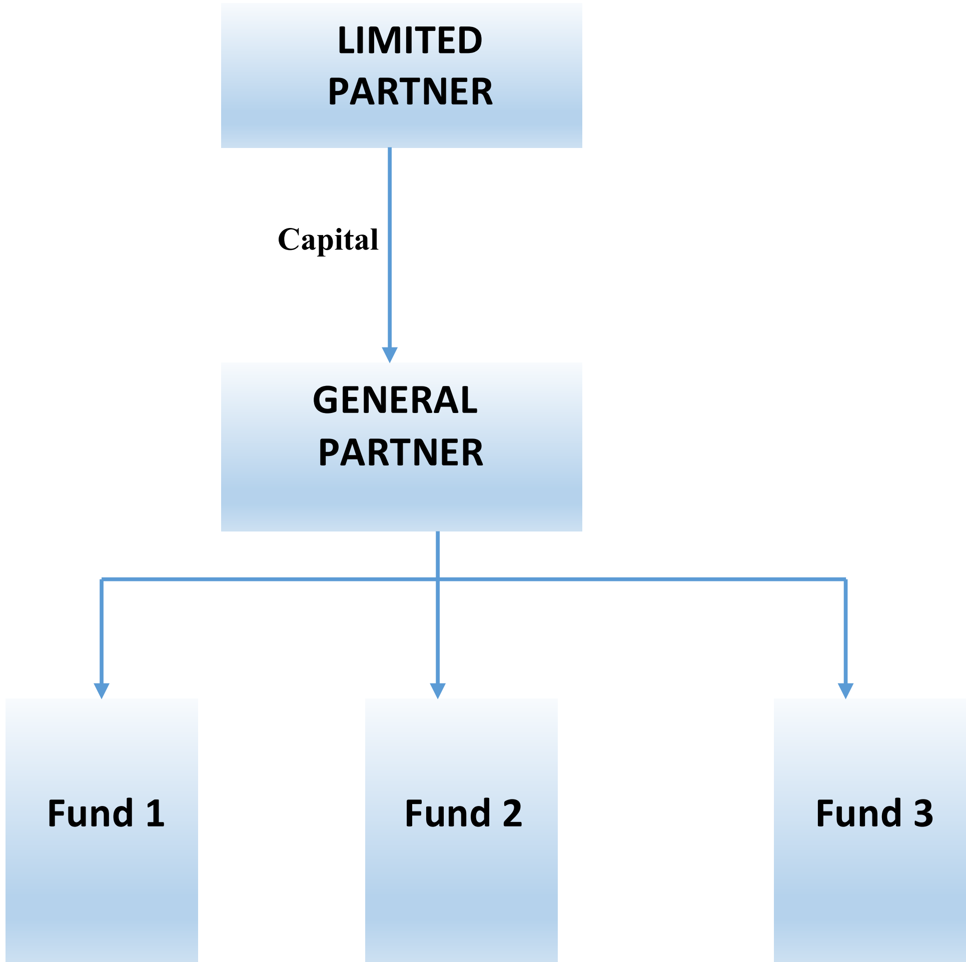
According to the article five states in the U.S, Connecticut, Illinois, Massachusetts, New York and New Jersey have introduced legislation that would impose a so-called privilege or carried interest "fairness" tax. The aforementioned states have large number of investment managers.

Private Equity Model

Generally, most of the PE firms charge a fee, which is called 2:20 ratio in the management circles. They initially take the share in the amount which is used to finance the fund. This share is nearly 2 percent on an average. However, large Private Equity firms charge a bit less than 2 percent whereas small PE firms charge slightly above 2 percent.

The managers take a standard fee of 2 percent as mentioned above and it is taxed as ordinary income at 35 percent to 40 percent. There is no avoiding this ordinary tax. The structure of the management is board is broadly into two groups. The first one being the Limited Partners and the second one being the General Partners. The Limited partners as the name suggests have a limited role on the decisions made in the firm. They actually provide the financial support for the fund through the firm. These Limited Partner (LPs as commonly referred) are "generally the Pension Funds, University Endowments, Sovereign Wealth Funds" and Wealthy Families. The PE firms usually do not take money from lower wage employees because they are severely affected when crisis occurs. That is why they choose to accept finance from the sources who are financially strong and can accept risks.

The General Partners are actually the managers of the PE firm who run the business. They have technical expertise with no financial support and that is why Limited Partners provide them with the capital which is required to invest in the fund. The General Partners invest in a firm which has good potential to succeed in the future but no financial support. They also invest in startups with a good scope. When they invest into any business, they acquire a certain share in it so that it has decision making ability in the business.



The funds mentioned in the above diagram could be any companies and startups. But, generally speaking PE firms do not invest into startups because there already exist Venture Capital firms. So, PE firms invest into the business which has good potential in the future to generate positive cash flows. They acquire the business using a model called Leverage Buyout Model (also called LBO Model). By using this model, they inject Debt into the business through Leverage which is provided by financial sponsor (in this case the Wealth Funds and other sources as mentioned earlier). When a business or a company has substantial amount of Debt it obviously gets delisted from the stock exchange and goes private from public. After restructuring the business, they sell it for profit and share it with the Limited Partners. They make profits by going public again through Initial Public Offering (IPO) where the management can make loads of money through that. The profit generated from the funds is distributed to the LPs above the Hurdle Rate. Hurdle Rate is the rate which is promised to the Limited Partners before the profits from the sale of funds are even distributed. The typical Hurdle rate is 8 percent for the Investors. After the amount which is obligated to give to the Investors as part of the Hurdle rate the profits from the funds gets distributed in 20:80 ratios. Meaning, that the LPs get 80 percent as part of their profit and the General Partners receive 20 percent as part of their profit share.

Example:

Let us consider that the Limited Partner has provided a capital of $2 billion. And the General Partner has invested those $2 billion in three funds.

Solution:

As mentioned earlier the Private Equity Firm charges a standard of 2 percent fee which is called Management Fee.

2 percent of $2 billion = $40 million

The management already gets $40 million as compensation even before investing into the funds. Now, it has **$2 billion - $40 million = $1.96 billion** to invest into the funds it has chosen. Let us consider it has four funds to invest $1.96 billion to invest in.

FUND	MONEY INVESTED	MONEY MADE	PROFIT
FUND 1	$490 million	$760 million	$270 million
FUND 2	$490 million	$690 million	$200 million
FUND 3	$490 million	$710 million	$220 million
FUND 4	$490 million	$400 million	$90 million
TOTAL	$1.96 billion	$2.56 billion	$600 million

(**NOTE:** The numbers in the above figure are purely taken for understanding purpose and are not taken from any sources)

From the above figure, it is clearly evident that not all the funds are profitable in the end. Therefore, the funds that are in loss are offset by the funds which are profitable. The amount $1.96 billion is invested into the funds after taking the management fee. This management fee is charged irrespective of the performance of the funds. The funds are generally hold for a period of 10 years on an average and in the end not all the funds are in profits. The profits generated by the funds are then first taken by the General Partners which is nearly 20 percent and then distributed to the Limited Partners. The share of the profits taken by the PE firm is called "Performance Fee".

The Performance fee is called "carried interest". This is where things get interesting. The carried interest in actually a provision which is provided by the tax authorities. There are many reasons why the tax authorities provide this provision. This helps to improve the overall economic benefit of the country, because surely investing activities improve the money circulation within the economy and hence supports to increase the GDP rate.

Short-term versus Long-term Capital Gains

In order to explain the "difference between short-term and long-term capital gains", we first need to understand the terminology behind it. "Short-term capital gains" are the gains that are produced by an asset after selling it for holding it for less than one year. The asset does not have to gain profits but it can also incur losses to the seller. For example, let us consider a stock (asset), within a span of one year it can either appreciate or depreciate in value. If the stock is sold with appreciation, then the profit made thorough that stock is taxed as ordinary income which is 35 percent to 40 percent. If the stock gets depreciated within one year, then it is filed as capital loss to the tax department and no tax is paid on losses.

In contrast, the opposite for "short-term capital gains" holds true for "long-term capital gains". "Long-term capital gains are the profits made" from an asset after "holding it for more than one year". "The long-term capital gains" tax is way less than the short-term capital gains which is “taxed as ordinary income”. For theoretical purpose, if a PE firm buys a company and restructures it and then sells the business for profit in under one year, then the profits made by the PE firm are taxed at 40 percent according to the US Tax Policy. But, that never happens in reality because it is impossible to generate profits in short-term.

The rate at which “long-term capital gains” is taxed varies among 0 percent, 10 percent, 15 percent and 23.8 percent (including Obamacare surtax which is 3.8 percent). For an individual who pays at 10 – 15 percent tax as ordinary income does not have to pay anything on his long-term capital gains. The individuals who are in the “tax bracket of 25, 28, 33 and 35 percent” pay 15 percent as their “long-term capital gains tax”. The individuals who are in the “highest tax bracket” of 40 percent pay 20 percent on their profits earned through sale of long-term assets.

The performance fee which is charge by managers in the PE firms actually comes under long-term capital gains because they hold an asset for more than one year (generally 10 years) and pay a maximum of 23.8 percent on those profits. Now, an ordinary individual has one source of ordinary income and pays it under ordinary income rate. Whereas, the PE managers pay management fee as ordinary income and performance fee also called “carried interest” loophole as long-term capital gain.

The **Form 8949** contains any “sale or other dispositions of capital assets”. In this form, the description of the property, which could be a land, building, company, stock etc. is entered in column (a). The “date of acquisition of this property” is entered in the column (b) with exact date, month and year of purchase. In column (c) the date of disposition of the asset is entered just like in column (b). Then, in column (d) proceeds from the asset are entered. In column (e) basis value is entered, which means usually what is paid for the asset. However, column (f) is left blank, if there is any adjustment, enter the code from the instructions to Form 8949 and the amount of the adjustment. In column (h) the difference in amount between column (d) and column (e) is calculated and the resulted amount is added to the adjustments made in column (g). If the proceeds are less than tax basis, then there is a loss incurred. The Form is not just used for one asset, but for multiple assets and then the tax is incurred on the Net Profit from “both short-term and long-term capital gains.”

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Form **8949**

Department of the Treasury
Internal Revenue Service

Sales and Other Dispositions of Capital Assets

▶ Go to *www.irs.gov/Form8949* for instructions and the latest information.

▶ File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074

2017

Attachment Sequence No. **12A**

Name(s) shown on return	Social security number or taxpayer identification number

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are short term. For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☐ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
☐ **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	**Adjustment, if any, to gain or loss.** If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.**		(h) **Gain or (loss).** Subtract column (e) from column (d) and combine the result with column (g)
					(f) Code(s) from instructions	(g) Amount of adjustment	
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 1b** (if **Box A** above is checked), **line 2** (if **Box B** above is checked), or **line 3** (if **Box C** above is checked) ▶							

Note: If you checked Box A above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37768Z Form **8949** (2017)

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Source: IRS (This form is taken from IRS website solely for educational purpose)

SCHEDULE D
(Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR.
▶ Go to *www.irs.gov/ScheduleD* for instructions and the latest information.
▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.

OMB No. 1545-0074

2017

Attachment Sequence No. **12**

Name(s) shown on return | **Your social security number**

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b .				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 .	**4**	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	**5**	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions	**6**	( )
7 **Net short-term capital gain or (loss).** Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back	**7**	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b .				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked.				

11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	**11**	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	**12**	
13 Capital gain distributions. See the instructions	**13**	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	**14**	( )
15 **Net long-term capital gain or (loss).** Combine lines 8a through 14 in column (h). Then go to Part III on the back	**15**	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H **Schedule D (Form 1040) 2017**

Source: IRS (This form is taken from IRS website solely for educational purpose)

"**Schedule D (Form 1040)** is used to report the following":

"1) The sale or exchange of a capital asset not reported on another form or schedule."
"2) Gains from involuntary conversions (other from casualty or theft) of capital assets not held for business or profit."
"3) Capital gain distributions not reported directly on Form 1040 (or effectively connected capital gain distributions not reported directly on Form 1040NR)."
"4) Non business bad debts." (IRS, n.d.)

There are two Publications for Form 1040. **Publication 544** states explains "the tax rules that apply when one disposes the property. It discusses how to figure gain (loss), whether it is ordinary or capital, how to treat gain or loss, and how to report gains and losses." "**Publication 550** discusses the tax treatment of investment income and expenses. It explains what investment income is taxable, what investment expenses are deductible, and how to show them on tax return." Both the Forms go hand in hand. In general Form 8949 is a fundamental for filling out Form 1040.

Since, the "investors are Pension Funds, University Endowments and Sovereign Wealth funds", the taxes paid by them on long-term capital gains are bit low than individuals because of the privileges received by them from the Government. They receive the privileges because they are basically functioning for a specific sector in the economy and work for a specific cause just like charitable trusts.

Conclusion

The reason why many "carried interest" enthusiasts call for a breakdown on carried interest breakdown is because they want all the employees to be treated equally. That being said, there would be no answers from those people if their long-term capital gains tax should also be treated as compensation. The reason that, PE fund managers, Hedge Fund managers and others dealing with carried interest privilege are taking large sum of amount should not be the sole criteria for eliminating carried interest. They are also taking significant amount of risks even before making profits from their investment. This statement goes apt with the one mentioned in the Introduction where the ship captain is also paid for the risk he has taken for sailing from one continent to another. If in case, the government looks to crackdown on “carried interest”, there are other for those firms to look into. For example, they could create a subsidiary in a Tax Haven country and transfer royalty payments to those subsidiaries and finally shift their profits to that country. There is also one more possibility for the managers. They can potentially increase their Performance Fee from 20 percent to 35 percent and can look to compensate for the minimization in their profit share. This could possibly make the situation of the University Endowments worse, because less share in profits means hike in University fee to the students and this could affect the middle-class sector in the country. This could potentially hamper the growth of the country as well. When PE firms and Hedge Funds make more business, it helps in increasing the job opportunities and this can contribute to increase in economic growth.

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