

# UNDERSTANDING THE EFFECT OF CARRIED INTEREST PROVISIONS ON FAIRNESS AND EQUALITY IN THE TAXATION OF HEDGE FUND PROFITS

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## I. INTRODUCTION

Private equity and hedge fund managers (General Partners) typically receive a percentage share of the profits from the funds that they manage as part of their compensation for managing the investments made by investors. This compensation is commonly referred to as “Carried Interest.” General Partners are then entitled to a more favorable tax treatment of their compensation—as compared to most other taxpayers—by deferring the tax on Carried Interest and having it taxed at a lower, preferential rate. Many view these Carried Interest tax provisions as providing an unfair and unjustified tax advantage. This paper will explore alternatives that would arguably create a more equitable framework for taxing Carried Interest.

General Partners have shrewdly incorporated Carried Interest into their form of compensation and benefitted from its favorable tax treatment. The provisions governing the taxation of Carried Interest have allowed General Partners to characterize Carried Interest as capital gain, benefitting from the lower tax rates.<sup>1</sup> The taxation of Carried Interest as capital gain has been around for decades, saving its beneficiaries billions of dollars in taxes.<sup>2</sup> This

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<sup>1</sup> See generally Brian DeChesare, *The Private Equity Partner: Is It Good to Be King?*, MERGERS & INQUISITIONS, <https://mergersandinquisitions.com/private-equity-partner/> (last visited Oct. 9, 2022) (discussing the average salary and amount of Carried Interest General Partners take in a tax year).

<sup>2</sup> See generally Mary Childs & Kenny Malone, *Carried Interest Wormhole*, NPR: PLANET MONEY (Aug. 12, 2022), <https://www.npr.org/2022/08/12/1117305695/carried-interest-wormhole> (discussing and tracing the history of Carried Interest from the eleventh century to its place in American society in present times); see generally *Tax Carried Interest as Ordinary Income*, CONG. BUDGET OFF. (Dec. 13, 2018), <https://www.cbo.gov/budget-options/2018/54795> (discussing amount of tax

paper will explore how the Carried Interest provisions of the Internal Revenue Code (IRC) minimize General Partners' tax liability and how these provisions should be reformed.<sup>3</sup>

General Partners of private equity funds and hedge funds benefit from favorable tax treatment of Carried Interest under the IRC.<sup>4</sup> A General Partner's compensation is mainly derived from the Carried Interest in the funds that they manage and the accompanying beneficial tax effects.<sup>5</sup> Carried Interest for General Partners can often account for eighty percent to eighty-five percent of their total income for the year.<sup>6</sup> Carried Interest provisions are then taxed at a long-term capital gains rate rather than being taxed as ordinary income.<sup>7</sup> This provision in the tax code has resulted in a reduction in tax revenues of billions of dollars.<sup>8</sup> It is also unclear whether the returns from Carried Interest are derived in the United States or abroad, due to the difficulty in tracking where investment firms are allocating their capital, unless they are publicly traded funds.<sup>9</sup>

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dollars lost to the preferential tax benefit General Partners receive with respect to Carried Interest).

<sup>3</sup> See generally Sabrina Parys & Tina Orem, *2021-2022 Tax Brackets and Federal Income Tax Rate*, NERDWALLET (July 14, 2022), <https://www.nerdwallet.com/article/taxes/federal-income-tax-brackets> (discussing the 2021 federal income tax brackets and tax rates); see generally *Key Elements of the U.S. Tax System*, TAX POL'Y CTR.: BRIEFING BOOK, <https://www.taxpolicycenter.org/briefing-book/what-carried-interest-and-how-it-taxed#:~:text=Carried%20interest%20is%20a%20contractual,and%20bonds%20C%20and%20private%20businesses.> (May 2020) (discussing the amount and tax rate each individual taxpayer is responsible for in taxes subject to their income and wages in a given tax year).

<sup>4</sup> Childs & Malone, *supra* note 2.

<sup>5</sup> See generally DeChesare, *supra* note 1.

<sup>6</sup> Greg Iacurci, *Carried Interest Provision is Cut from Inflation Reduction Act. How This Tax Break Works, and How It Benefits High-Income Taxpayers*, CNBC (Aug. 8, 2022, 3:06 PM), <https://www.cnbc.com/2022/08/08/what-carried-interest-is-and-how-it-benefits-high-income-taxpayers.html>.

<sup>7</sup> Carlos Micames, *The Tax Loophole No One is Talking About: Carried Interest*, AM. U. BUS. L. REV., <https://aublr.org/2020/02/the-tax-loophole-no-one-is-talking-about-carried-interest/> (last visited Oct. 9, 2022).

<sup>8</sup> CONG. BUDGET OFF., *supra* note 2.

<sup>9</sup> Donald J. Marples, *Taxation of Carried Interest*, CONG. RSCH. SERV. (Aug. 4, 2022), <https://crsreports.congress.gov/product/pdf/R/R46447>.

This comment argues that Carried Interest should be taxed as ordinary income as opposed to capital gain, ensuring that this provision is applied in a fair manner consistent with other IRC provisions. This comment will discuss the foundational principles of the current American tax system, what Carried Interest is, and the general beneficiaries of these provisions. This comment will also discuss the public and congressional response to the tax treatment of Carried Interest over the past fifteen years. Finally, this comment will offer two solutions to the issue presented. The first solution will posit that Carried Interest should be taxed as ordinary income. The second solution is that if Carried Interest is to continue to be taxed at capital gains rates, it should be limited to Carried Interest earned on domestic investments.

## II. BACKGROUND

This section will provide a general introduction into the federal income tax system, Carried Interest, and the beneficiaries of Carried Interest compensation. It will then provide an explanation of the federal progressive income tax system, and how the federal government collects Federal income tax generally, to ensure an equitable system. Next, a brief introduction to Carried Interest compensation methods and their origins will be discussed. Finally, this section will conclude with a broader description of General Partners and their investment strategies.

### A. *Progressive Income Tax System*

The United States has a progressive income tax system of increasing tax rates as a taxpayer's taxable income increases.<sup>10</sup> The progressive tax system works as a system of layers where each layer or "bracket" is taxed at an increasingly higher rate.<sup>11</sup> As a taxpayer earns more taxable income, the taxpayer pays increasingly higher rates as their taxable income passes through each respective bracket.<sup>12</sup>

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<sup>10</sup> I.R.C. § 1.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

Taxable income is a taxpayer's gross income minus deductions in a particular tax year.<sup>13</sup> For the purposes of this paper, the most important point to note is that taxpayers in the highest marginal tax bracket pay tax at a rate of thirty-seven percent on increases in their income.<sup>14</sup>

The tax brackets for single filers in 2021 break down as follows: ten percent for taxpayers with taxable income of \$10,275 or less, twelve percent for taxpayers with taxable income between \$10,276 and \$41,775, twenty-two percent for taxpayers with taxable income between \$41,776 and \$89,075, twenty-four percent for taxpayers with taxable income between \$89,076 and \$170,050, thirty-two percent for taxpayers with taxable income between \$170,051 and \$215,950, thirty-five percent for taxpayers with taxable income between \$215,951 and \$539,900, and thirty-seven percent for taxpayers with taxable income of \$539,901 and over.<sup>15</sup> These rates are then indexed for inflation year over year as economic circumstances change.<sup>16</sup>

Under the federal tax system, a taxpayer would then pay each layer of taxable income with respect to the corresponding tax bracket.<sup>17</sup> For example, a taxpayer that has a taxable income of \$50,000 would pay ten percent tax on the first \$10,275 of taxable income, then the next chunk of taxable income would be taxed at twelve percent, then whatever remains of the \$50,000 of taxable income would be taxed at twenty-two percent. The progressive tax system in America is intended, from a taxpayer policy, to tax income in higher tax brackets at a higher rate, presumably because these individuals should bear a higher tax burden than individuals with less gross income.<sup>18</sup>

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<sup>13</sup> § 63.

<sup>14</sup> § 1.

<sup>15</sup> Rev. Proc. 2021-45, 2021-48 I.R.B. 764.

<sup>16</sup> I.R.C. § 1.

<sup>17</sup> Rev. Proc. 2021-45, 2021-48 I.R.B. 764.

<sup>18</sup> CFI Team, *Progressive Tax*, CFI, <https://corporatefinanceinstitute.com/resources/knowledge/accounting/progressive-tax-system/> (last visited Mar. 4, 2022).

In contrast to the taxation of ordinary income at progressively higher rates, capital gains are taxed at 23.8% at the time of realization, rather than at ordinary income rates.<sup>19</sup>

### B. *Carried Interest and its Origins*

Although Carried Interest has only arisen as a point of issue in the United States more recently, it is a concept that dates back centuries.<sup>20</sup> Carried Interest is a contractual right that allows General Partners of hedge funds, private equity funds, and venture capital firms to share in a particular fund's profit.<sup>21</sup> Often described as a "tax loophole," the Carried Interest tax provisions provide that income earned subject to these provisions is taxed at a capital gains rate as opposed to the higher ordinary income rate.<sup>22</sup>

The General Partner's compensation derived from the fund typically constitutes 20% of the profit of the fund plus a 2% management fee of the fund.<sup>23</sup> This compensation is then only taxed at a 23.8% tax rate, reflecting a long-term capital gain, rather than as ordinary income in the 37% tax bracket.<sup>24</sup> The favorable tax treatment General Partners receive results in the loss of over a billion dollars of tax revenue each year than had their income instead been taxed at ordinary income rates.<sup>25</sup>

The Carried Interest tax provisions have come under increasing scrutiny in recent years.<sup>26</sup> Carried Interest compensation methods as a concept, however, have existed for centuries.<sup>27</sup> Carried Interest compensation methods date back to the Mediterranean spice

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<sup>19</sup> See discussion on capital gains tax rates *infra* text accompanying notes 61-87, note 76.

<sup>20</sup> Becky Sullivan, *A Tax Loophole Made Fund Managers Rich. Closing it May Help Pay for the Climate Bill*, NPR: POL. (Aug. 3, 2022), <https://www.npr.org/2022/08/03/1115218183/carried-interest-close-tax-loophole>; Childs & Malone, *supra* note 2.

<sup>21</sup> TAX POL'Y CTR.: BRIEFING BOOK, *supra* note 3.

<sup>22</sup> Childs & Malone, *supra* note 2.

<sup>23</sup> Sullivan, *supra* note 20.

<sup>24</sup> Micames, *supra* note 7.

<sup>25</sup> CONG. BUDGET OFF., *supra* note 2.

<sup>26</sup> Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 8 (2008).

<sup>27</sup> Sullivan, *supra* note 20; Childs & Malone, *supra* note 2.

shipping trade of 1163.<sup>28</sup> Wealthy merchants at the time often did not want to take on the risk and time necessary to engage in the physical shipping of their product, preferring to stay home while their product traveled by ship from Italy to Egypt.<sup>29</sup> This being the case, merchants would look to another, often younger, person to physically ship and watch over their product.<sup>30</sup> This practice presented an issue for both the stay-at-home merchant and the traveling merchant.

The traveling merchant was taking a risk posed to his life, given the dangers of the time (pirates and sickness), and the stay-at-home merchant was taking the risk that the traveling merchant would sell his product and take off with the money.<sup>31</sup> The solution that evolved from this issue is that the stay-at-home merchant would offer the traveling merchant a share of the profits from the endeavor.<sup>32</sup> Although the traveling merchant may still take the money and run, it made more sense long-term for the traveling merchant to continue the partnership with the stay-at-home merchant and keep getting a cut of the profits.<sup>33</sup>

This Medieval Era arrangement is the world's first example of a profit share given in a shared risk-taking venture, a forerunner to Carried Interest.<sup>34</sup> This form of Carried Interest was considered controversial even at the time.<sup>35</sup> It was thought that the practice mentioned above was a sly way to disguise a loan, which in early Christian, Islamic, and Jewish societies was illegal if the loan was accompanied with interest.<sup>36</sup> Often, this arrangement between merchants amounted to a simple loan, in that the stay-at-home merchant was merely loaning his product to the traveling merchant, and the traveling merchant then had to pay back the stay-at-home merchant the price of the product plus profits.<sup>37</sup> People at the time

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<sup>28</sup> Childs & Malone, *supra* note 2.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> Childs & Malone, *supra* note 2.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

believed that the profit could be characterized as “interest,” which would constitute usury.<sup>38</sup>

This is all to say that even in medieval times, people engaged in the practice of what came to be known as Carried Interest had to be careful in how they labeled their investments, an issue that still presents itself in current times.<sup>39</sup>

In 1954, section 702 of the Internal Revenue Code was enacted.<sup>40</sup> Section 702 allowed General Partners to apply the long-term capital gains tax rate to Carried Interest arrangements, which at the time was twenty-five percent.<sup>41</sup> Approximately ten years later, tax professionals began to advise their clients to categorize the taking of profits from a fund as “performance reallocation,” now known commonly as Carried Interest.<sup>42</sup> Sixty years later, tax professionals continue to advise clients that Carried Interest should be taxed at capital gains rates.

### C. *Hedge Funds, Private Equity, and General Partners*

A General Partner typically holds the highest position in a private equity or hedge fund firm.<sup>43</sup> The day-to-day work of a General Partner usually involves four tasks: fundraising, deal sourcing, firm representation and team building, and final investment decisions.<sup>44</sup> Fundraising involves a General Partner soliciting Limited Partners to invest capital into the General Partner’s particular fund.<sup>45</sup> General Partners also engage in deal sourcing, consisting of finding new companies and areas of interest to invest in.<sup>46</sup> General Partners also approve final investment decisions, directing how capital will be employed by the fund.<sup>47</sup>

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<sup>38</sup> *Id.* Usury is the illegal action or practice of lending money at unreasonably high rates of interest.

<sup>39</sup> *Id.*

<sup>40</sup> Internal Revenue Act of 1954, Pub. L. No. 83-591, § 702, 68A Stat. 3.

<sup>41</sup> I.R.C. § 702 (1954); Childs & Malone, *supra* note 2.

<sup>42</sup> Childs & Malone, *supra* note 2.

<sup>43</sup> DeChesare, *supra* note 1.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

General Partners also represent the firm in the media and at professional conferences, and make hiring decisions to grow their firms.<sup>48</sup> The typical annual salary of a General Partner ranges from \$700,000 to \$2,000,000, but this does not account for the significant amount of compensation that a General Partner will earn through the Carried Interest provisions in their compensation.<sup>49</sup> In a typical fund that performs well, a General Partner will be contractually entitled to receive 20% of the profits from a fund's investment, plus a 2% management fee.<sup>50</sup> The 20% share represents the profits earned by the fund, which is referred to as the Carried Interest.<sup>51</sup> This potentially could account for millions of dollars of additional compensation being paid to the General Partner, which is taxed at the preferential long-term capital gains tax rate of 23.8% , rather than as ordinary income.<sup>52</sup> Carried Interest often times could make up to 80% to 85% of the General Partner's compensation for the year, which is then only taxed at 23.8%.<sup>53</sup> In comparison, their annual salary could potentially be taxed at a marginal tax rate of 37% , resulting in significant tax savings for a General Partner.<sup>54</sup>

#### D. Hedge Fund Investment

An investment firm will generally strategically decide whether to invest domestically or in foreign direct investments.<sup>55</sup> An investment firm is not bound to choose one option over the other, and successful firms generally do not, preferring to invest their

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<sup>48</sup> *Id.*

<sup>49</sup> DeChesare, *supra* note 1.

<sup>50</sup> *Id.*; Brian DeChesare, *Private Equity Salary, Bonus, and Carried Interest Levels: The Full Guide*, MERGERS & INQUISITIONS, <https://mergersandinquisitions.com/private-equity-salary/> (last visited Mar. 6, 2024).

<sup>51</sup> Fleischer, *supra* note 26.

<sup>52</sup> Micames, *supra* note 7.

<sup>53</sup> *Id.*; James Chen, *Carried Interest Explained: Who It Benefits and How It Works*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/carriedinterest.asp> (last updated Feb. 23, 2024).

<sup>54</sup> Micames, *supra* note 7; Chen, *supra* note 53.

<sup>55</sup> Cecile Fruman & Xavier Forneris, *The False Debate Choosing Between Promoting FDI and Domestic Investment*, WORLD BANK: PRIV. SECTOR DEV. BLOG (June 6, 2016), <https://blogs.worldbank.org/psd/false-debate-choosing-between-promoting-fdi-and-domestic-investment>.



capital both in domestic or in foreign investments.<sup>56</sup> A foreign direct investment is an investment from a party in a business, firm, or asset located in a different country or jurisdiction.<sup>57</sup> This type of investment is made with the purpose of expanding into a foreign country, which in turn benefits the economy of the foreign country.<sup>58</sup> A domestic investment is an investment from one party into their home country.<sup>59</sup> Each have their own advantages and disadvantages.<sup>60</sup>

### III. POLICY ISSUES IN HOW CARRIED INTEREST COMPENSATION IS TAXED

Section III of this paper begins with a discussion of the link between Carried Interest compensation and the preferential capital gains tax rate and how they work together. It includes an explanation of the capital gains tax rate and how it is captured by a taxpayer. Next, it looks at how General Partners benefit from this beneficial tax provision and its effect on national revenue collection. Lastly, this section concludes with an examination of the differing viewpoints on the tax treatment of Carried Interest from the point of view of the public and policymakers.

#### A. *Carried Interest Characterized as Capital Gains*

A capital gain is generally characterized in the IRC as the gain derived from the sale of a capital asset.<sup>61</sup> Capital gains are included in taxable income but may be eligible to be taxed at a preferential

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<sup>56</sup> *Id.*

<sup>57</sup> CFI Team, *Foreign Direct Investment*, CFI (May 7, 2022), <https://corporatefinanceinstitute.com/resources/knowledge/economics/foreign-direct-investment-fdi/>.

<sup>58</sup> *Id.*

<sup>59</sup> See SAYEF BAKARI, *THE IMPACT OF DOMESTIC INVESTMENT ON ECONOMIC GROWTH: NEW EVIDENCE FROM MALAYSIA* 105 (2017).

<sup>60</sup> See *infra* text accompanying notes 153-98; *Id.*; See generally SGH, <https://sghiscock.com.au/the-pros-and-cons-of-foreign-direct-investment/> (last visited Oct. 9, 2022) (discussing the pros and cons of foreign direct investments).

<sup>61</sup> James Chen, *Capital Gains: Definition, Rules, Taxes, and Asset Types*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/capitalgain.asp> (last updated Feb. 26, 2024).

rate of up to 23.8% rather than at the higher rates imposed on ordinary income.<sup>62</sup> Though the tax rate for capital gains is 20%,<sup>63</sup> an additional 3.8% tax may apply (as it usually does for General Partners).<sup>64</sup> The additional 3.8% net investment income tax attaches to the 20% capital gains tax rate when a General Partner's net investment income, from sources such as, but not limited to, capital gains, and their adjusted gross income exceeds a certain amount.<sup>65</sup> This paper will assume, and to this point has assumed, that the General Partner will be subject to the 3.8% additional tax.

To better understand the character of a capital gain, why it receives a preferential tax treatment, and how Carried Interest falls under this umbrella, one must first understand what a capital asset is. A capital asset is generally considered to be property held by a taxpayer that is not necessarily connected to his trade or business.<sup>66</sup>

There are, however, several exceptions for the sale of property that do not fall under the definition of a capital asset such as: stock in trade or inventory,<sup>67</sup> property that is subject to allowance for depreciation,<sup>68</sup> patents or copyrights,<sup>69</sup> accounts or notes,<sup>70</sup> publications of the United States,<sup>71</sup> commodities,<sup>72</sup> hedging transactions,<sup>73</sup> and property used in the ordinary course of a trade or business.<sup>74</sup> In order to receive the preferential capital gains tax rate, capital assets must be classified as long-term capital gains.<sup>75</sup>

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<sup>62</sup> *Id.*; I.R.C. § 1(h)(D); § 1411.

<sup>63</sup> § 1(h)(D).

<sup>64</sup> § 1411; *What is Carried Interest Capital Gains?*, CTR. FORWARD (Sept. 3, 2021), <https://center-forward.org/what-is-carried-interest-capital-gains/#:~:text=Many%20of%20these%20partnerships%20are,proportion%20of%20the%20partnership's%20profits>.

<sup>65</sup> *What's Net Investment Income – and How Is It Taxed*, CHARLES SCHWAB, <https://www.schwab.com/taxes/net-investment-income-taxes> (last visited Jan. 22, 2023).

<sup>66</sup> I.R.C. § 1221.

<sup>67</sup> § 1221(a)(1).

<sup>68</sup> § 1221(a)(2).

<sup>69</sup> § 1221(a)(3).

<sup>70</sup> § 1221(a)(4).

<sup>71</sup> § 1221(a)(5).

<sup>72</sup> § 1221(a)(6).

<sup>73</sup> § 1221(a)(7).

<sup>74</sup> § 1221(a)(8).

<sup>75</sup> TAX POL'Y CTR.: BRIEFING BOOK, *supra* note 3.

This paper will primarily examine net capital gains<sup>76</sup> because it is this provision that will determine whether a taxpayer (General Partner for the purposes of this paper) will be eligible for the preferential capital gains tax rate on his or her Carried Interest compensation.<sup>77</sup>

Proponents of the long-term capital gains tax rate argue that the tax preference given encourages entrepreneurial risk taking and thus spurs economic growth and disincentives the sale of assets by subjecting capital gains to tax at lower rates.<sup>78</sup> Conversely, critics of the tax preference reference its disproportionate benefits to the wealthy, and its encouragement of investments that do not achieve these policy goals.<sup>79</sup>

Under IRC section 702, Carried Interest is income derived by the General Partner of a private equity firm or hedge fund that is taxed at the preferential long-term capital gains rate rather than being taxed as ordinary income.<sup>80</sup> Instead of representing the profit from appreciation in their investments, General Partners receive Carried Interest as compensation for investment management services and strategies, something that would appear to more closely

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<sup>76</sup> To correctly arrive at a taxpayer's net capital gain, the taxpayer must first go through the netting process. A taxpayer's understanding of the netting process first requires an understanding of the types of capital gains and losses that must be netted together. A long-term capital gain is the gain from the sale or exchange of a capital asset held for more than one year. A short-term capital gain is the gain from the sale or exchange of a capital asset held for less than one year. A long-term capital loss is the loss from the sale or exchange of a capital asset held for more than one year. A short-term capital loss is the loss from the sale or exchange of a capital asset held for less than one year. A taxpayer's net long-term capital gain is, then, the excess of their long-term capital gains over their long-term capital losses. Conversely, a taxpayer's net short-term capital loss is the excess of their short-term capital losses over their short-term capital gains. Finally, a taxpayer arrives at their net capital gain by taking the excess of their net long-term capital gain over their net short-term capital loss for that tax year. If a taxpayer has a net capital gain at this point, then the long-term capital gains tax rate may apply. *See generally* § 1222; *Topic No. 409, Capital Gains and Losses*, IRS, <https://www.irs.gov/taxtopics/tc409>.

<sup>77</sup> *See generally* I.R.C. § 1222; § 1(h)(D).

<sup>78</sup> TAX POL'Y CTR.: BRIEFING BOOK, *supra* note 3.

<sup>79</sup> *Id.*

<sup>80</sup> I.R.C. § 702(d); Micames, *supra* note 7.

resemble compensation for investment services or advising.<sup>81</sup> Because Carried Interest depends on the profitability of a fund's investments, it is considered contingent upon future performance and is not taxable at the time of grant, characterizing it as a capital asset.<sup>82</sup>

General Partners have been able to characterize Carried Interest into a long-term capital gain by contributing some of their own capital into a fund, so their own monetary wellbeing is at risk.<sup>83</sup> However, the capital a General Partner contributes will typically only make up one to five percent of the fund investment.<sup>84</sup> This amount, however, is still considered to be enough to qualify the receipt of Carried Interest as long-term capital gains taxed at preferential tax rates as opposed to ordinary income.<sup>85</sup>

It is worth noting that taxation of Carried Interest is not a uniquely American tax preference.<sup>86</sup> Currently, in the United Kingdom, second to the United States in terms of the number of investment firms, Carried Interest is typically characterized as gains and not as ordinary income, allowing it to be taxed at eighteen percent.<sup>87</sup>

#### *B. The Wealth Multiplier: General Partners and Carried Interest*

General Partners have characterized Carried Interest as capital gains for the past seventy years.<sup>88</sup> The only change to the application of the Carried Interest provisions came in 2017 with the Tax Cuts and Jobs Act, discussed in a subsequent section, requiring General Partners to hold their interests in a fund for three years

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<sup>81</sup> TAX POL'Y CTR.: BRIEFING BOOK, *supra* note 3.

<sup>82</sup> Micames, *supra* note 7.

<sup>83</sup> Fleischer, *supra* note 26.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> See generally 2007 Pre-Budget Report and Comprehensive Spending Review, THE NAT'L ARCHIVES (Oct. 9, 2007), <https://webarchive.nationalarchives.gov.uk/ukgwa/20140109143644/http://www.hmrc.gov.uk/pbr2007/pbrn17.pdf>.

<sup>87</sup> The Finance Act, (2019) § 1H(2), UK PUB. GEN. ACTS (Eng.).

<sup>88</sup> See generally Fleischer, *supra* note 26.

rather than one year to capture the long-term capital gains tax rate.<sup>89</sup> This, however, has done little to change the actual tax treatment of Carried Interest, and thus has been largely ineffective in increasing national revenue.<sup>90</sup>

General Partners typically derive Carried Interest by taking 20 percent of the profits of a fund and then taking a two percent management fee.<sup>91</sup> For managing a partnership, a General Partner normally receives two percent of the fund's committed capital.<sup>92</sup> This management fee is classified as ordinary income.<sup>93</sup> Then, a General Partner will also usually share in the profits of a well-performing fund and carry over the interest from this profit share at twenty percent.<sup>94</sup> Depending on how a General Partner characterizes this profit share, it will most often be characterized as a long-term capital gain.<sup>95</sup>

For example, the General Partner of a small private equity or hedge fund may potentially earn a base salary ranging from \$200,000 to \$700,000.<sup>96</sup> If the General Partner manages a fund that profits \$20,000,000 and takes the typical profit share of 20%, they would be earning \$4,000,000.<sup>97</sup> Although the base salary and the 2% management fee will be taxed as ordinary income, if the General Partner holds this \$4,000,000 for more than three years before realizing it, the larger sum of \$4,000,000 will only be taxed at the capital gains rate of 23.8%.<sup>98</sup> It has been estimated that not characterizing Carried Interest as ordinary income has resulted in General Partners reducing their tax liability by approximately fourteen billion dollars in taxes in the past ten years.<sup>99</sup>

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<sup>89</sup> I.R.C. § 1061(a)(2); H.R. 1, 115th Cong. (2017).

<sup>90</sup> See generally Fleischer, *supra* note 26; see generally Micames, *supra* note 7.

<sup>91</sup> Fleischer, *supra* note 26.

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> Micames, *supra* note 7.

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*; CONG. BUDGET OFF., *supra* note 2.

<sup>99</sup> CONG. BUDGET OFF., *supra* note 2.

C. *Challenges to Carried Interest Tax Provisions*

Carried Interest being taxed at the preferential long-term capital gains rate has not been without its critics for the past fifteen years.<sup>100</sup> This criticism has been bipartisan.<sup>101</sup> The past two Presidents are among those who have made critical comments of the preferential tax treatment allowed for Carried Interest.<sup>102</sup>

In 2016, a campaigning Donald J. Trump said, “We will eliminate the [C]arried [I]nterest deduction, well-known deduction, and other special-interest loopholes that have been so good for Wall Street investors and for people like me but unfair to American workers.”<sup>103</sup> Trump continued his critique of the tax benefit afforded to General Partners, stating: “[t]he hedge fund guys didn’t build this country . . . [t]hese are guys that shift paper around, and they get lucky . . . they are paper pushers. They make a fortune. They pay no tax. It’s ridiculous . . . .”<sup>104</sup>

In 2020, a campaigning Joe Biden vowed he would “eliminate special tax breaks that reward special interests and get rid of the capital gains loophole for multimillionaires.”<sup>105</sup>

Biden was more specific than Trump by offering a plan to eliminate the preferential tax treatment Carried Interest receives.<sup>106</sup> Biden noted he would eliminate the benefits of Carried Interest by taxing long-term capital gains as ordinary income.<sup>107</sup>

Critics highlight that the Carried Interest provisions appear to only benefit wealthy taxpayers.<sup>108</sup> Some General Partners of investment firms have even become critics of the tax benefit they

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<sup>100</sup> See generally *id.*; see generally Sullivan, *supra* note 20; see generally Alan Rappeport et al., *The Carried Interest Loophole Survives Another Political Battle*, N.Y. TIMES (Aug. 5, 2022), <https://www.nytimes.com/2022/08/05/business/carried-interest-senate-bill.html>.

<sup>101</sup> Sullivan, *supra* note 20.

<sup>102</sup> Rappeport et al., *supra* note 100.

<sup>103</sup> *Id.*

<sup>104</sup> James B. Stewart, *A Tax Loophole for the Rich That Just Won’t Die*, N.Y. TIMES (Nov. 9, 2017), <https://www.nytimes.com/2017/11/09/business/carried-interest-tax-loophole.html>.

<sup>105</sup> Rappeport et al., *supra* note 100.

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> Sullivan, *supra* note 20.

receive.<sup>109</sup> In July 2022, Bill Ackman, a General Partner of a large New York City investment firm—while conceding that preferential tax treatment is important for the founders of new businesses themselves—said that this preferential tax treatment afforded to people like himself is a “is a stain on the tax code.”<sup>110</sup>

Ackman went on further with his critique of the tax treatment allowed for Carried Interest for General Partners, stating that “[i]t does not help small businesses, pension funds, other investors in hedge funds or private equity and everyone in the industry knows it. It is an embarrassment[,] and it should end now.”<sup>111</sup> One of America’s wealthiest men, Warren Buffet, advocated for the end of the preferential tax treatment allowed to Carried Interest by pointing to the unfairness in the fact that he pays less in taxes than his secretary.<sup>112</sup>

#### D. *Proponents’ View of Carried Interest*

As one might imagine, for every issue, there are people debating each side. General Partners are the largest group of advocates for the preferential tax treatment given to Carried Interest.<sup>113</sup> And if it is not General Partners themselves advocating for the preferential tax treatment they benefit from, among other issues that affect the investment industry, it is the lobbyists and politicians’ investment firms that pay (or in the case of politicians, contribute to their campaign) approximately \$627,000,000 per year to do it for them.<sup>114</sup>

When arguing for the preservation of the preferential tax treatment given to Carried Interest, General Partners assert that the provision is important to motivate them to invest in the economy.<sup>115</sup>

One lobbyist characterized General Partners as such when he said, “The private equity industry directly employs over 11 million

<sup>109</sup> See generally Rappeport et al., *supra* note 100.

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> Stewart, *supra* note 104.

<sup>113</sup> See generally Rappeport et al., *supra* note 100.

<sup>114</sup> Carter Dougherty, *Private Equity and Hedge Funds Spent \$627 mn on Politics in 2019-20*, AMERICANS FOR FIN. REFORM (Oct. 25, 2021), <https://ourfinancialsecurity.org/2021/10/report-private-equity-and-hedge-fund-money-in-politics/>.

<sup>115</sup> Rappeport et al., *supra* note 100.

Americans, fuels thousands of small businesses and delivers the strongest returns for pensions.”<sup>116</sup> A General Partner at an investment firm applauded the decision of the denial of a bill that would have eliminated the preferential tax treatment by stating, “We’re happy to see . . . recognition of the role that private capital plays in growing of businesses and the economy.”<sup>117</sup>

More specifically, when discussing the potential adverse effects of eliminating the preferential tax treatment given to Carried Interest, the argument is four-pronged.<sup>118</sup> First, proponents argue that a change in the tax law would result in a reduced incentive for General Partners to invest in the economy.<sup>119</sup> As a result, many businesses that benefit from capital received from these investment firms could potentially struggle to find financing and could ultimately fail.<sup>120</sup>

Second, going hand-in-hand with proponents’ first argument, jobs could be lost in the economy.<sup>121</sup> Third, proponents argue state, federal, and local tax revenues could decline in the next ten years because General Partners will not make as much money and will be able to contribute less in taxes.<sup>122</sup> Their final argument is that investors in these funds could lose money if these provisions were changed.<sup>123</sup>

*E. Legislative Proposals Targeting the Preferential Tax Treatment Afforded to Carried Interest*

As policy makers became more aware of the taxation of Carried Interest, numerous legislative reforms were advanced to eliminate

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<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> See generally Charles Swenson, *Impact on Jobs, Tax Revenue, and Economic Growth of Proposed Tax Increase on Carried Interest*, U.S. CHAMBER OF COM. CTR. FOR CAP. MARKETS COMPETITIVENESS (Fall 2021), <https://www.centerforcapitalmarkets.com/resource/impact-on-jobs-tax-revenue-and-economic-growth-of-proposed-tax-increase-on-carried-interest/>.

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*



it. The first attempt appeared to be by Representative Sander M. Levin in 2007.<sup>124</sup>

Congress began to hold hearings to gauge the wisdom of taxing Carried Interest as ordinary income and changing the current tax structure in general.<sup>125</sup> Levin then offered a revised version of his original legislation; however, the meat of the resolution remained unchanged in the notion that Carried Interest would still be taxed as ordinary income under the revised resolution.<sup>126</sup> Levin, ever persistent, again introduced legislation in 2012 named the Carried Interest Fairness Act to make an attempt at passing a bill to tax Carried Interest as ordinary income.<sup>127</sup> Levin's last attempt at Carried Interest taxation reform came in 2015 when he attempted to pass a bill to tax Carried Interest as ordinary income.<sup>128</sup>

The beneficial treatment of the Carried Interest tax was not only of importance to the Democratic party. In 2014, Republican U.S. Representative Dave Camp drafted legislation that would raise the tax rate on Carried Interest from the applicable long-term capital gains tax rate to thirty-five percent.<sup>129</sup>

In the end, however, none of these legislative proposals were successful. The only meaningful change to Carried Interest taxation came in 2017 as part of President Trump's Tax Cuts and Jobs Act, which increased the long-term capital gains holding period on partnership profits from one year to three years.<sup>130</sup>

#### F. *Presidential Comments on Carried Interest*

Since 2007, every U.S. President has commented on the preferential tax treatment afforded to Carried Interest.<sup>131</sup> In a White

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<sup>124</sup> H.R. 2834, 110th Cong. (2007).

<sup>125</sup> See *On the Taxation of Carried Interest: Hearing Before the S. Fin. Comm.*, 110th Cong. (2007) (testimony of Eric Solomon, Assistant Sec'y for Tax Policy, U.S. Dep't. of the Treasury); see H.R. 2834, 110th Cong. (2007).

<sup>126</sup> H.R. 1935, 111th Cong. (2009).

<sup>127</sup> H.R. 4016, 112th Cong. (2012).

<sup>128</sup> H.R. 2889, 114th Cong. (2015).

<sup>129</sup> H.R. 1, 113th Cong. (2014).

<sup>130</sup> I.R.C. § 1061(a)(2); Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054.

<sup>131</sup> See generally *President Bush Discusses American Competitiveness Initiative During Press Conference*, THE WHITE HOUSE: PRESIDENT GEORGE W.

House press conference, George W. Bush offered brief remarks on the issue, while Barack Obama, Donald Trump, and Joe Biden offered more narrow remarks on the Carried Interest issue and vowed to eliminate its preferential tax rate.<sup>132</sup>

As Carried Interest first became a topic of national discussion in 2007 and 2008, Bush, in response to a question of whether he thought it was fair for Carried Interest to be taxed at the long-term capital gains rate, said:

[W]hat ends up happening is that in trying to deal with one particular aspect of partnerships is that you end up affecting all partnerships. And partnerships are an important vehicle to encourage investment and capital flows. They've been important vehicles to encourage the entrepreneurial spirit -- in other words, small businesses have been organized as limited partnerships. So we're very, very hesitant about trying to target one aspect of limited partnerships for fear of the spillover it'll have in affecting small business growth. So we don't support that.<sup>133</sup>

Bush would be the only President of the four mentioned to have a favorable view of the current taxation of Carried Interest.

Obama first publicly commented on Carried Interest in 2013 when he signaled that he intended to raise the tax rate on Carried Interest to raise tax revenues needed to fund social programs.<sup>134</sup> In 2015, Obama vowed to end the preferential tax treatment for Carried Interest, saying that raising the Carried Interest tax rate "is an example of how we can maintain fiscal responsibility while at the

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BUSH (Aug. 9, 2007, 10:33 AM), <https://georgewbush-whitehouse.archives.gov/news/releases/2007/08/20070809-1.html>; *see also* *Obama Questions 'Carried Interest' Tax Break*, CNBC: POL., <https://www.cnbc.com/2013/02/03/obama-questions-carried-interest-tax-break.html> (Feb. 4, 2013, 5:46 PM); *see also* Stewart, *supra* note 104; *see also* Rappeport et al., *supra* note 100.

<sup>132</sup> *See generally* THE WHITE HOUSE: PRESIDENT GEORGE W. BUSH, *supra* note 131; CNBC: POL., *supra* note 131; Stewart, *supra* note 104; Rappeport et al., *supra* note 100.

<sup>133</sup> THE WHITE HOUSE: PRESIDENT GEORGE W. BUSH, *supra* note 131.

<sup>134</sup> CNBC: POL., *supra* note 131.

same time making the investments we need to grow.”<sup>135</sup> Obama went further, adding, “I will tell you that keeping this tax loophole, which leads to folks who are doing very well paying lower rates than their secretaries, is not helping the American economy . . . .”<sup>136</sup> Obama would mix his public posturing with action by proposing an increase to the long-term capital gains tax rate as it relates to Carried Interest in his 2010, 2011, and 2012 budget outlines, although they would ultimately not be enacted.<sup>137</sup>

Trump publicly voiced his opposition to the Carried Interest tax rate.<sup>138</sup> Trump would ultimately come up short of raising the tax rate on Carried Interest in the Tax Cuts and Jobs Act, which only increased the holding period on Carried Interest to catch the preferential long-term capital gains tax rate.<sup>139</sup>

Biden has twice attempted to eliminate the beneficial tax treatment afforded to Carried Interest. Biden would initially place a provision in his Build Back Better proposal to raise the tax rate on Carried Interest to 39.6 percent.<sup>140</sup> This proposal was blocked in the Senate by members of Biden’s own political party.<sup>141</sup> Biden would

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<sup>135</sup> Hazel Bradford, *Obama Calls for End to Carried Interest*, PENSIONS & INVESTMENTS (Sept. 16, 2015, 1:00 AM), <https://www.pionline.com/article/20150916/ONLINE/150919919/obama-calls-for-end-to-carried-interest>.

<sup>136</sup> *Id.*

<sup>137</sup> *Tax Carried Interest as Ordinary Income*, TAX POL’Y CTR.: 2010 BUDGET TAX PROPOSALS, [https://web.archive.org/web/20120128080632/http://www.taxpolicycenter.org/taxtopics/2010\\_budget\\_carriedinterest.cfm](https://web.archive.org/web/20120128080632/http://www.taxpolicycenter.org/taxtopics/2010_budget_carriedinterest.cfm) (last visited Oct. 16, 2022); *Tax Carried Interest as Ordinary Income*, TAX POL’Y CTR.: 2011 BUDGET TAX PROPOSALS, [https://web.archive.org/web/20120129192512/http://www.taxpolicycenter.org/taxtopics/2011\\_carried\\_interest.cfm](https://web.archive.org/web/20120129192512/http://www.taxpolicycenter.org/taxtopics/2011_carried_interest.cfm) (last visited Oct. 16, 2022); *Tax Carried Interest as Ordinary Income*, TAX POL’Y CTR.: 2012 BUDGET TAX PROPOSALS, <https://web.archive.org/web/20120129071857/http://www.taxpolicycenter.org/taxtopics/Tax-Carried-Interest-as-Ordinary-Income.cfm> (last visited Oct. 16, 2022).

<sup>138</sup> Rappeport et al., *supra* note 100; Stewart, *supra* note 104.

<sup>139</sup> I.R.C. § 1061(a)(2).

<sup>140</sup> CTR. FORWARD, *supra* note 64; H.R. 5376, 117th Cong. § 138202 (2021).

<sup>141</sup> Kelly Anne Smith & Korrena Bailie, *Biden’s Build Back Better Plan is Dead. Now What?*, FORBES: ADVISOR (Mar. 2, 2022 1:12 PM), <https://www.forbes.com/advisor/personal-finance/build-back-better-plan-dead/>.

then try to raise the tax rates of Carried Interest in the Inflation Reduction Act.<sup>142</sup> Biden would be curbed again by a member of his own political party when the provision to raise the tax rates on Carried Interest was taken out of the Inflation Reduction Act before it was passed.<sup>143</sup> Although Biden still has time to make good on his promise to raise tax rates on Carried Interest, he will need support within his own political party to make it happen.

As it currently stands, three consecutive U.S. Presidents have vowed to raise the tax rates on Carried Interest, and none have been successful.

#### IV. FOREIGN DIRECT INVESTMENTS VS. DOMESTIC INVESTMENTS

Investment firms have two general forms of ‘geographical’ investment strategies for investing in firms, companies, or assets at their disposal: foreign direct investments and domestic investments.<sup>144</sup> A foreign direct investment is an investment made from a party in one country into an asset, whatever it may be, in another country.<sup>145</sup> Conversely, a domestic investment is an investment made from a party into their home country.<sup>146</sup> The advantages and disadvantages of each respective form of investment will be discussed further below.

##### A. *Foreign Direct Investments: Advantages and Disadvantages*

In the investment firm industry, a foreign direct investment is generally considered to be an investment where the firm committing the capital acquires a ten percent or greater ownership stake in a foreign asset.<sup>147</sup> Although ten percent ownership does not give the investment firm a controlling interest in the asset, it does allow them

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*See generally* Inflation Reduction Act of 2022, Pub. L. No. 117-169, 136 Stat. 1818.

<sup>142</sup> Rappeport et al., *supra* note 100.

<sup>143</sup> *Id.*

<sup>144</sup> Fruman & Forneris, *supra* note 55.

<sup>145</sup> CFI Team, *supra* note 57.

<sup>146</sup> *See generally* Bakari, *supra* note 59.

<sup>147</sup> SGH, *supra* note 60.

to have influence over decisions, such as the management, operations, and policies.<sup>148</sup> Foreign direct investments are critical for developing countries because the companies in these countries need the investments to expand their international sales.<sup>149</sup> Furthermore, the countries themselves need the capital to ensure and improve their infrastructure.<sup>150</sup>

There are generally two main types of foreign direct investments: vertical investments and horizontal investments.<sup>151</sup> Vertical foreign direct investments occur when “a business expands into a foreign country by moving to a different level of the supply chain.”<sup>152</sup> In other words, the business would be conducting different activities in the foreign country than it would in its home country.<sup>153</sup> Horizontal foreign direct investments occur when a business expands its domestic operations to the host country of the foreign direct investment.<sup>154</sup> The business would thus conduct the same activities it does in its home country but in the foreign country instead.<sup>155</sup> These two types of foreign direct investments are both achieved by capital provided from investment firms.<sup>156</sup>

#### i. Advantages

There are many advantages to engaging in foreign direct investments, both for the investing party and the host country beneficiary.<sup>157</sup>

The investing party receives the benefit of geographic investment diversification when engaging with foreign direct investments.<sup>158</sup> This allows the investing party to achieve greater fund efficiency by diversifying their holdings outside of their own country and political system (read as, for the purposes of this paper,

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<sup>148</sup> *Id.*

<sup>149</sup> *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> See generally CFI Team, *supra* note 57.

<sup>152</sup> *Id.*

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> *Id.*

<sup>156</sup> *Id.*

<sup>157</sup> SGH, *supra* note 60.

<sup>158</sup> *Id.*

tax system).<sup>159</sup> And, going hand-in-hand with the above mentioned benefit, investment firms that engage in foreign direct investments receive the same Carried Interest beneficial tax incentives.<sup>160</sup> Additionally, a business that engages in foreign direct investments will potentially receive the benefit of lower labor costs, preferential tariffs, and greater subsidies.<sup>161</sup>

The host country receiving the foreign direct investment also benefits in a variety of ways.<sup>162</sup> First, foreign direct investments provide the host country with economic stimulation.<sup>163</sup> Foreign direct investments create a more conducive environment for the beneficiaries of the investment to stimulate the local and national economy.<sup>164</sup> Foreign direct investments potentially operate to make international trade easier.<sup>165</sup> Many countries have their own import tariffs, and foreign direct investments function to make these tariffs more manageable for both the investing party and the host country beneficiary.<sup>166</sup> In favor of a global economy, foreign direct investments also potentially stimulate the exchange of resources, knowledge, technology, and skills between countries.<sup>167</sup> This transfer would then increase the productivity and efficiency of the host country beneficiary's work force.<sup>168</sup> Lastly, foreign direct investments may benefit a host country in the form of human capital development and increased employment.<sup>169</sup>

## ii. Disadvantages

Economically, capital inflow from foreign direct investment may be accompanied by higher, long-term outflows of capital that do not benefit the host country beneficiary.<sup>170</sup> This effect results in

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<sup>159</sup> *Id.*

<sup>160</sup> *Id.*

<sup>161</sup> CFI Team, *supra* note 57.

<sup>162</sup> SGH, *supra* note 60.

<sup>163</sup> *Id.*

<sup>164</sup> *Id.*

<sup>165</sup> *Id.*

<sup>166</sup> *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> SGH, *supra* note 60.

<sup>169</sup> CFI Team, *supra* note 57.

<sup>170</sup> SGH, *supra* note 60.

the possible displacement of local businesses, as the entrance of large foreign companies—possibly linked to foreign direct investments—drive out the local businesses that cannot compete because of the amount of capital backing the foreign companies.<sup>171</sup> Profit repatriation presents another potential disadvantage.<sup>172</sup> Many investment firms will not reinvest in the business situated in the host country, leading to large capital outflows.<sup>173</sup> Potential exploitative practices may also stem from foreign direct investments.<sup>174</sup> Once the investing party has enough of a stake to dictate policy through foreign direct investments, they may then over-exploit human and natural resources, such as unfair labor prices and land waste that damages the environment.<sup>175</sup> Due to these concerns, many countries have regulations that limit foreign direct investment.<sup>176</sup>

### B. Domestic Investments: Advantages and Disadvantages

Typically, in the United States, foreign direct investments place second to the benefits that domestic investments provide.<sup>177</sup> Foreign direct investments can only work to enhance the benefits that domestic investments already provide.<sup>178</sup> It thus follows that, generally, there first must be an infrastructure of strong domestic investment strategy before the issuance of foreign direct investments.<sup>179</sup>

#### i. Advantages

The main benefit attributed to domestic investments is job creation.<sup>180</sup> In general, domestic investments in a home country work to create more jobs than could be attributed to any type of foreign direct investment.<sup>181</sup> The impact of domestic investments is

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<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> *Id.*

<sup>174</sup> *Id.*

<sup>175</sup> *Id.*

<sup>176</sup> CFI Team, *supra* note 57.

<sup>177</sup> *See generally* Fruman & Forneris, *supra* note 55.

<sup>178</sup> *Id.*

<sup>179</sup> *See generally id.*

<sup>180</sup> *Id.*

<sup>181</sup> *Id.*

better judged by looking at the long-term effects rather than looking at its short-term impact.<sup>182</sup> When measured in the long-term, many positive effects are attributable to domestic investments in the areas of exports and increased job growth.<sup>183</sup>

The positive effects are seen in other obvious places that affect the day-to-day life of a country's population, such as improved infrastructure, including: roads, extensions of water and sewage connections, increases in urban plans and construction, housing, and extensions of electric grids.<sup>184</sup> The social benefits of domestic investments are seen in the improvement of education, health, and communication projects.<sup>185</sup> Finally, when looking at the economic benefits, domestic investments are linked to an improvement in agriculture, industry, and tourism.<sup>186</sup> Private domestic investments, such as those from investment firms, are crucially important in a country's ability to produce new sources of goods and services to stimulate economic growth.<sup>187</sup>

## ii. Disadvantages

The disadvantages that come from domestic investments seem to be minimal. The most common disadvantage cited from purely engaging in domestic investments seems to be less compensation for those making the investments.<sup>188</sup> And, it can only be said to be a disadvantage due to the existence of foreign direct investments.<sup>189</sup> If investment firms were forced to only engage in domestic investments, their return on investment would be less than if they were to diversify their investments through foreign direct investments that benefit foreign countries, rather than their home country.<sup>190</sup>

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<sup>182</sup> Bakari, *supra* note 59, at 105.

<sup>183</sup> *Id.*

<sup>184</sup> *Id.* at 106.

<sup>185</sup> *Id.*

<sup>186</sup> *Id.*

<sup>187</sup> Muhammed Saleem & Rummana Zaheer, *A Study on Influence of Domestic Investment on the Economic Growth from 1980-2016*, 6 J. OF GLOB. ECON. 1, 1 (2018).

<sup>188</sup> See generally SGH, *supra* note 60.

<sup>189</sup> See generally *id.*

<sup>190</sup> *Id.*



## V. SOLUTIONS TO CARRIED INTEREST

The taxation of Carried Interest at the long-term capital gains rate for General Partners is an unfair and unequitable system that is much more beneficial to the wealthy taxpayer than it is for the average American taxpayer. In the interest of building a more equitable tax system, this paper offers two separate solutions. Option one is to tax Carried Interest as ordinary income to promote fairness and equity in the tax code. Option two offers flexibility and allows General Partners to continue to benefit from the preferential tax treatment they receive on Carried Interest so long as they commit to engaging primarily in domestic investments rather than foreign direct investments.

A. *Option One*

The first option would be to tax Carried Interest as ordinary income. An argument can be made that Carried Interest is the return of a General Partner's labor and should therefore be taxed as ordinary income.<sup>191</sup> This seems to be the most popular solution to the problem as American legislators have spent the past fifteen years introducing legislation to enforce this change.<sup>192</sup> It would also be the least burdensome solution due to the complexity of separating the Carried Interest earned domestically as opposed to abroad.<sup>193</sup>

Opponents to taxing Carried Interest as ordinary income could argue that it would encourage General Partners to engage in riskier investments to earn the same compensation considering the loss of the Carried Interest tax benefit. However, this argument is flawed because it is unclear why a change in the tax rate would change where investors distribute capital and not just how much capital they invest into an asset they already hold. More simplistically, a General Partner's ability to find avenues to greater profit of a particular fund is why they are so well paid regardless of the tax benefit they

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<sup>191</sup> DONALD J. MARPLES, CONG. RSCH. SERV., R46447, *TAXATION OF CARRIED INTEREST* 5 (2022) (General Partners that are acting as advisers and managers of a hedge fund or investment fund appear to be providing services as opposed to making an investment and are thus providing "labor").

<sup>192</sup> *Id.* at 1.

<sup>193</sup> *Id.* at 8.

receive. It is difficult for a beneficiary of the taxation of Carried Interest compensation to suggest that the elimination of the tax provision would make their job harder, as the difficulty of the job would seem to be why they are compensated as well as they are.

The other argument proponents of the current taxation system applied to Carried Interest cling to is that they view themselves as business owners (the fund being their business) and they should therefore receive long-term capital gains rates upon the sale of this business for their “ent[repreneurial] value[.]”<sup>194</sup> Though this argument may hold some weight if a fund is a publicly traded asset, it breaks down when considering private funds and fund operations because profits from a business are already generally treated as ordinary income under the current tax system. Additionally, it is not as if these General Partners are selling the entire fund, but finally realizing the wages of their labor. This would be more akin to the commission of a salesman (which is taxed as ordinary income) rather than the sale of an entire business.

i. Implementation

With new reform, potential resistance comes from the industry that may be affected. Any change in the tax law to how partnerships, such as investment funds, are taxed could result in unintended consequences to the taxation of other industries, such as small business. A small business owner is typically in a lesser financial situation than an investment fund and probably has a greater need for the preferential tax treatment that the long-term capital gains rate provides. For this reason, it would be wise for Congress to limit any language regarding tax reform to Carried Interest or investment funds to best promote equity and fairness in taxation.

B. *Option Two*

The second option to address the issue of General Partners taxing Carried Interest at the preferential long-term capital gains rate is to tax Carried Interest derived from foreign direct investments as ordinary income but allow Carried Interest derived from domestic investments to retain the favorable taxation of the long-term capital

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<sup>194</sup> *Id.* at 5-6.

gains rate. This solution is proposed to recognize the importance that private sector capital investments offer to a country's economy and to encourage those private sector capital investments to primarily remain in the home country where these investment firms operate.<sup>195</sup>

The argument is that the taxation of Carried Interest at capital gains rates should be continued if these investments were made domestically. Assuming the foregoing, General Partners would continue to be driving the American economy, through capital investments, in a way that directly impacts the ordinary American taxpayer through domestic business growth, job creation, and wealth. With four of the top five locations for hedge funds and private equity firms being located in the United States and with New York City hedge funds holding 100 percent more assets than the next closest city, London, this solution would continue to benefit American businesses and companies in terms of capital investment.<sup>196</sup> Thus, with the wealth of investing power residing within its own borders, American investment firms could better serve the American economy and people by choosing to invest in American businesses rather than businesses abroad.

Practical difficulties may arise with only extending the tax benefit to domestic investment. First, it would require transparency from General Partners in how much and where their investments are allocated, and the subsequent profit that is attributed to these investments. One way to achieve this level of transparency would be for investment firms to become public entities.<sup>197</sup> Investment firms that become public are required to file quarterly and annual financial statements and to make full disclosures to the Securities and Exchange Commission.<sup>198</sup> However, so long as investment firms choose to remain private, it is difficult to gauge where their investments are being allocated to.<sup>199</sup>

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<sup>195</sup> See generally Saleem & Zaheer, *supra* note 187.

<sup>196</sup> *Top 12 Cities for Hedge Fund Jobs*, HEDGE FUND JOB DIG., <https://www.jobsearchdigest.com/hedge-fund-jobs/career-advice/top-cities-for-hedge-fund-jobs/> (last visited Oct. 22, 2022).

<sup>197</sup> CONG. RSCH. SERV., R46447, at 3.

<sup>198</sup> *Id.*

<sup>199</sup> *Id.* at 1-2.

Investment firms, both public and private, could lessen this burden by committing to disclose to IRS regulators that their profits and compensation are mainly coming from domestic investments rather than foreign direct investments. The other option, if investment firms refuse to comply with disclosure, would be to statutorily require that investment firms disclose the source of their investments if they want to be eligible for preferential tax rates.

The other issue with this solution is the amount of faith Americans must place into businesses and corporations to use capital investments they receive to stimulate the American economy and keep jobs and production in America. In total 14.3 million jobs are currently outsourced from American companies.<sup>200</sup> More than eighty-four percent of outsourcing deals globally come from the United States, accounting for the United States losing 300,000 jobs annually from this practice.<sup>201</sup> In sum, even if investment firms devoted themselves to investing in the American economy, Americans would have to rely on their own companies and businesses to keep jobs and production in the country. To stop this practice of widespread outsourcing, some type of legislative intervention to limit outsourcing or place an outright ban on the practice will need to be taken. If this widespread practice of outsourcing is not curbed, then it will not matter if capital investments remain domestic because the American companies receiving the benefit will render the effort obsolete by using the investments to further enhance their operations abroad.

## VI. CONCLUSION

Taxing Carried Interest as ordinary income is the most feasible route to solving the issue in the current American tax system. Applying long-term capital gains tax rates to Carried Interest is an issue that has drawn the ire of three past presidents (one Republican, two Democrat) and has received bipartisan legislation to address it.<sup>202</sup> If the attack across the political landscape earnestly persists,

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<sup>200</sup> *Outsourcing Statistics 2022: In the US and Globally*, TEAMSTAGE, <https://teamstage.io/outsourcing-statistics/> (last visited Oct. 22, 2022).

<sup>201</sup> *Id.*

<sup>202</sup> See generally Sullivan, *supra* note 20.

this is a solution that can be implemented to put a stop to the current unfair taxation system as it applies to Carried Interest.

In the trying economic times that the United States currently faces; the country must do everything it can to raise revenue. It is only fair that those with the deepest pockets finally pay their fair share.