Appendix VII –
Background on Carried Interest Provision

Carried Interest Provision in 2009 Tax Extenders Bill
(Venture Capital Compensation Issue)

ACS Staff Paper, Summer 2010

The Issue

For more than 30 years, carried interest has been taxed at the long-term capital gains tax rate. This tax rate has served as an incentive for long-term investment in high-risk, start-up companies. However, Congress has recently proposed to change the tax rate to ordinary income in order to raise revenue to pay for tax credits, such as the R&D tax credit,which expired at the end of 2009. This policy would essentially double the taxes for venture capitalists (VCs). The venture capital system in the United States is critical to starting new companies that can lead to job growth. Because building companies is a long-term undertaking, the capital gains tax incentive is a critical part of the equation, both for VCs and for entrepreneurs. By including VCs in the carried interest changes, the government will be negatively impacting job growth over the long term. Fewer VCs and fewer venture funds mean fewer start-ups and fewer jobs for the economy.

Background & Status

On December 9, 2009, as part of legislation extending expiring tax provisions H.R.4213, the House of Representatives passed a provision to change the tax treatment of partnership-carried interest from capital gains to ordinary income. The bill has since been referred to the Senate Finance Committee and is currently waiting for floor time after the Financial Reform Bill is passed. If signed into law, this would result in a tax increase from the current capital gains tax rate of 15 percent to ordinary income rates as high as 35 percent on many real extate development partnerships, venture capital firms, hedge funds and other limited liability companies (LLCs) that utilize carried interest.

This is the third time a carried interest tax increase has been passed by the House of Representatives, having failed on the two prior occasions to pass the Senate. The proposal is described by its supporters as intended to eliminate the capital gains treatment for carried interest paid to Wall Street private equity, hedge fund managers, real estate ventures and venture capital firms

Venture Capital Firm Compensation

Venture capitalists are compensated through a combination of management fees and carried interest (often referred to as a “two and 20” arrangement):

- Management fees – an annual payment made by the investors in the fund to the fund’s manager to pay for the private equity firm’s investment operations. In a typical venture capital fund, the general partners receive an annual management fee equal to up to two percent of the committed capital.

- Carried interest – a share of the profits of the fund (typically 20 percent) paid to the private equity fund's management company as a performance incentive. The remaining 80 percent of the profits are paid to the fund's investors.

Strong Limited Partner interest in top-tier venture firms has led to a general trend toward terms more favorable to the venture partnership, and certain groups are able to command carried interest of 25-30 percent on their funds.

Sources

National Venture Capital Association. Update on Proposed Changes to Carried Interest Tax Rate, position statement. Arlington, VA., 2010.

Univest, Inc. What is Venture Capital? http://www.univestinc.com (accessed August, 2011)