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COMMENTARY

The Trump Administration's Proposed Carried Interest Tax Reform

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The Trump White House has reignited the carried interest debate. On February 6, the White House announced that President Trump intends to change the tax treatment of carried interest as part of Republicans' broader budget plans.[1] While framed as a crackdown on tax loopholes, the move raises broader questions about how tax policy should balance fairness and economic growth.

Carried interest is the portion of investment fund profits allocated to fund managers as compensation. It is currently taxed at the lower long-term capital gains rate of 20% rather than the ordinary income tax rate of up to 37%.[2] Proponents argue that this structure incentivizes investment and economic growth, while critics claim it provides an unjust tax break for wealthy fund managers.[3]

Supporters of the current system emphasize its role in promoting risk-taking and capital formation.[4] Venture capital and private equity investments often fund businesses that might otherwise struggle to secure financing, particularly in high-risk, high-growth sectors such as technology and biotech.[5]

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1 Elliott Brown, *Carried Interest Tax Rate Comes Under Fire, Again, from Trump*, WALL ST. J. (Feb. 7, 2025), https://www.wsj.com/livecoverage/jobs-report-stock-market-today-dow-nasdaq-sp500-02-07-2025/card/carried-interest-tax-rate-comes-under-fire-again-from-trump-3GY6k57VL6ujN9SshtMh.

2 James Chen, *Carried Interest Explained: Who It Benefits and How It Works*, INVESTOPEDIA (July 2, 2024), https://www.investopedia.com/terms/c/carriedinterest.asp.

3 Tobias Burns, *Republicans weigh ending Wall Street's favorite tax break*, THE HILL (Feb. 12, 2025), https://thehill.com/business/5138964-carried-interest-tax-break-republicans/.

4 Owen Davis, *What Is The Carried Interest Loophole?*, INT'L BUS. TIMES (Sept. 16, 2015), https://www.ibtimes.com/what-carried-interest-tax-loophole-2100059.

5 *Id.*

Reform advocates argue that carried interest is compensation for labor—managing investments on behalf of others—and should be taxed as ordinary income.[6] Carried interest reform has also become a populist political symbol, frequently framed as a "loophole" that benefits only a small group of ultra-wealthy Americans.[7]

For nearly two decades, lawmakers on both sides of the aisle have tried and repeatedly failed to reform the current structure.[8] The most significant recent change occurred under Trump's 2017 Tax Cuts and Jobs Act, which extended the holding period for carried interest to qualify for capital gains treatment from one year to three years.[9] While this modest change increased the time frame required to secure the lower tax rate, it left the fundamental structure intact. Now, with Trump wielding more influence than in 2017 and bipartisan support for reform, this may be the closest the U.S. has come to an overhaul.[10]

While the specifics of Trump's proposal remain unclear, past reform efforts suggest two potential approaches. The first is extending the holding period beyond the current three years. Democrats previously proposed a five-year holding period,[11] though industry leaders state that it would take a 10- or 20-year extension to significantly impact investment behavior.[12]

The second, more drastic proposal is to reclassify all carried interest as ordinary income, making it subject to the higher income tax rate instead of the lower capital gains rate. Democratic Senator Tammy Baldwin recently introduced a bill to this end.[13] While this approach would generate more tax revenue than simply extending the holding period, it could have far-reaching consequences for investor behavior, fund structures, and capital markets.

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[6] *Id.*

[7] Kevin D. Williamson, *Bad Medicine on 'Carried Interest'*, NATIONAL REVIEW (Mar. 30, 2017), https://www.nationalreview.com/2017/03/tax-reform-carried-interest-donald-trump-democrats/.

[8] See, e.g., Andrew Duehren, *Sen. Kyrsten Sinema Wins Tax Changes to Democrats' Climate Bill*, WALL ST. J., (Aug. 4, 2022), https://www.wsj.com/articles/kyrsten-sinema-gop-fuel-fears-for-fate-of-democrats-climate-plan-11659618001.

[9] Richard Rubin & Miriam Gottfried, *Democrats Ready Carried-Interest Tax Hike After 15-Year Lobbying Campaign*, WALL ST. J. (July 28, 2022), https://www.wsj.com/articles/democrats-ready-carried-interest-tax-hike-after-15-year-lobbying-campaign-11659029989.

[10] Sam Sutton & Declan Harty, *Why this carried interest fight is different*, POLITICO (Feb. 18, 2025), https://www.politico.com/newsletters/morning-money/2025/02/18/why-this-carried-interest-fight-is-different-00204631.

[11] Rubin & Gottfried, *supra* note 9; Duehren, *supra* note 8.

[12] Rubin & Gottfried, *supra* note 9 (quoting Michael Arougheti of Ares Management Corporation and Steve Rosenthal of the Tax Policy Center).

[13] *Tammy Baldwin Proposes Legislation To Close Carried Interest Tax Loophole,* WRJN (Feb. 6, 2025), https://wrjn.com/news/2025/02/06/tammy-baldwin-proposes-legislation-to-close-carried-interest-tax-loophole.

Compared to merely extending the holding period, classifying all carried interest as ordinary income could lead to a fundamental shift in private investment incentives, with broader economic repercussions. Reclassifying carried interest as ordinary income would significantly increase the net effective investment cost, discouraging capital allocation to high-risk, high-growth sectors such as technology and biotech. Startups could see fewer funding opportunities, weakening economic dynamism and slowing job creation. The policy might satisfy political demands, but its economic consequences could outweigh any perceived fairness gains.

Beyond fund managers, higher management fees or reduced returns could also impact institutional investors like pension funds, university endowments, and nonprofits, for which private funds are key investment components.[14] The policy could also weaken investment decision-making by pushing top financial talent to other industries. With fewer skilled fund managers and higher costs, smaller and emerging funds may struggle to compete, consolidating more power within large firms that can better absorb a tax hike.

Despite the intense debate, closing the carried interest loophole would barely make a dent in the federal deficit—raising just $13-14 billion over a decade, according to estimates.[15] By contrast, the U.S. ran a $129 billion deficit in January alone.[16] Lawmakers should consider whether the economic risks are worth such limited gains.

Tax policy should be guided by substance, not symbolism. Reclassifying carried interest as ordinary income risks stifling investment, hurting startups, and consolidating power within large firms—all for negligible fiscal benefit.

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[14] Rita Astoor & Josephine Koh, *Venture capital fund structures*, CARTA (Aug. 30, 2022), https://carta.com/learn/private-funds/structures/ ("Often, LPs are institutional investors, such as pension funds, college endowments, [and] trusts."); James G. Baldwin, *What Is the Structure of a Private Equity Fund?*, INVESTOPEDIA (Aug. 29, 2024), https://www.investopedia.com/articles/investing/093015/understanding-private-equity-funds-structure.asp (listing pension funds and university endowments as common limited partners); Greg Young, *Is Private Equity Right for Your Foundation?*, BERNSTEIN PRIV. WEALTH MGMT., https://www.bernstein.com/our-insights/insights/2022/articles/is-private-equity-right-for-your-foundation.html (last visited Feb. 19, 2025) ("Many US tax-exempt organizations have also learned that seeking investments outside of volatile public markets can strengthen portfolios.").

[15] *Tax Carried Interest as Ordinary Income*, CONG. BUDGET OFF. (Dec. 12, 2024), https://www.cbo.gov/budget-options/60946; Brown, *supra* note 1 ("It was estimated [in 2022] that eliminating the tax would bring in $14 billion in government revenue over a decade.").

[16] *Current Federal Debt and Deficit*, PETER G. PETERSON FOUND., https://www.pgpf.org/programs-and-projects/fiscal-policy/current-debt-deficit/ (last visited Feb. 19, 2025).