THE UNFORESEEN IMPACT OF SWEEPING CHANGES TO THE **TAXATION FOR CARRIED INTEREST**

Carried Interest Helps Diverse Entrepreneurs Build Businesses & Achieve Wealth

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Private equity is an important source of economic activity in the United States. In 2020, the private equity sector directly employed 11.7 million workers who earned an average of $73,000 in wages and benefits. Suppliers to the sector employed an additional 7.5 million US. workers.[i] The financial incentives for professionals in private equity are substantially different from that of other financial sectors, like investment banking. General partners (GPs) in private equity do not receive the majority of their income by charging high management fees to investors or by betting on the failure of companies. Instead, they invest their sweat equity – years of their time, experience and knowledge – into helping businesses operate more effectively and increase in value. This sweat equity is a critical source of wealth building for GPs of color who, in most cases, could not otherwise invest equivalent amounts of money into other types of vehicles due to the dramatic wealth gap in the United States. It is also where the most profound indirect impacts on wealth generation and job creation occur, particularly for people of color, as private equity managers of color are more often likely to invest in minority-owned businesses than their white counterparts.

The United States faces a swelling gap between the wealth of whites and that of people of color. In 2016, the median wealth of white households was $171,000 - 900 percent and 730 percent greater than that of Black households ($17,100) and Hispanic households ($20,600) respectively.[ii] This immense disparity equates to a general incapacity of people of color to invest in the future and withstand the financial problems that disproportionately impact these same groups. Indeed, the economic recession arising from the 2008 financial crisis had a far more profound impact on people of color than it did on their white counterparts. According to an analysis by the Pew Research Center, while inflation-adjusted median wealth fell by 16 percent among white households between 2005 and 2009, it plummeted 66 and 53 percent among Hispanic and Black households, respectively. This effectively decimated the Black and Hispanic middle classes.[iii]

A key contributor to the racial wealth gap is the relatively low level of business ownership and ownership of more lucrative and/or diversified financial investments. Black and Hispanic Americans hold only 8 and 15 percent of their assets in businesses and financial assets relative to whites and Asian Americans, who hold approximately one-third of their assets in these ways.[iv] Increasing participation by people of color in private equity and venture capital is critical to helping this change, both directly by increasing the number of people of color serving as fund managers and receiving the financial returns to their investments, and by the greater propensity of these same people to invest in minority-owned businesses that have long suffered from lending discrimination from banks.

THE ROLE OF CARRIED INTEREST IN INCREASING THE ABILITY OF FUND MANAGERS OF COLOR TO BUILD WEALTH

The tax treatment of carried interest capital gains is an important tool for direct wealth creation. Carried interest capital gains treatment provides the opportunity for those who may not have financial capital but possess knowledge and expertise to share in the wealth generated by their investment of human capital. While GPs typically charge an annual management fee (dispersed among the employees in their firm) of about two percent of committed capital, for small and/or emerging funds, this does not amount to much. For example, a fund with $250 million receives only $5 million in management fees to cover the salaries of their entire team as well as operational and overhead expenses. Unlike other finance vehicles that serve as middlemen, such as investment banks, or those who exploit mispricing in securities, such as hedge funds or trading firms, private equity funds generate higher investment profits and create value for main street businesses over a longer course of time through their general partners investing their “sweat equity”. In order to realize carried interest (approximately 20 percent of the fund profits), general partners must invest their money, time and skills.

Private equity funds have an average lifespan of ten years, which includes the time to raise the fund – which may take two or more years – the time to source the deals and invest, the time to improve the fund's portfolio businesses, and the time to exit. The management fee covers basic operations of the fund, including base salaries and overhead.

"When the pie is smaller, there's less dollars to go around at the end of the day. And usually non-traditional, riskier investments are the first ones to get cut"

- MARTINA EDWARDS,
VENTURE PARTNER AT ZANE VENTURE FUND

This sweat equity investment, particularly for smaller and/or emerging funds and their investment staff, is critical to the success of the fund. It is not covered by management fees because it is, in fact, an investment and not a fee for service. Moreover, like any investment, its returns are not guaranteed. It is treated as a long-term capital gain because the assets - the businesses invested in -are capital assets, not income from the labor of day-to-day management.

If carried interest were taxed at a higher rate, the incentive for fund managers to hold, grow and develop companies would diminish and the lifespan of the funds would become substantially shorter. As Verdun Perry, Global Head Blackstone Strategic Partners, points out, "[p]eople will act the way they are incented to act" and the incentive would be to do things more quickly as the reward for holding assets long-term would diminish. Time, he explains, is a critical factor in this.

If carried interest is taxed at a higher rate, making the returns for fund managers lower, they will likely want, and, in the case of smaller, less established firms, need to exit earlier. This potentially destabilizes businesses and ultimately does the opposite of what private equity is meant to do which is to provide long-term, patient capital. “When something is bad for a big organization, it could be exponentially worse for smaller organizations.”

This has been the case throughout the Covid pandemic as well as the Great Recession; in the latter case, 40 percent of job losses were attributable to small businesses.[v]

The use of carried interest is, in fact, critical to aligning the interests of the Limited Partners (LPs) and GPs because, in most allocations of distributions between GPs and LPs (a.k.a. distribution waterfalls), GPs only receive carried interest when a fund generates profits above a specific hurdle rate. That rate is an internal rate of return (IRR) that is annualized, compounded, and must be returned to limited partners before GPs get a cut. This is typically between six and eight percent. The employment of carried interest incentivizes fund managers to take calculated risks based on their knowledge and skillsets, while limited partners are reassured about the GPs decisions since the latter do not make money unless the limited partners do and the hurdle rate has been reached.[1] For many, the risks are worth the rewards. Private equity produced average annual returns of 13.2 percent over the 15-year period ending in Q4 of 2020. During that same time, the Russell 2000 Index averaged 9.3 percent per year[vi] while the S&P 500 returned 9.2.

Although minority-owned private equity firms still comprise a disproportionately low share of private equity, there is a clear upward trend. This indicates a growing opening for professionals of color in private equity.

[1] It is important to acknowledge the distribution waterfall can actually have two basic variations: the European waterfall and the American waterfall (which are not delineated by location).

Between 2004 and 2016, minority-owned firms increased their representation by 33 percent (from 2.7 to 3.6 percent of all PE firms). Over that same time, these firms increased their assets under management (AUM) by 1,323 percent (from $1.3B to $18.5B).[vii] The increased AUM for minority-owned firms is emblematic of their high performance and increases the ability of these same firms to invest more in their second and latter funds and secure external funding. As a Black partner at a private equity firm with $3 billion in assets under management explains, “the more profit you are creating for your LPs along the way, the more they will be willing to commit to future funds. Limited partners see the confidence of general partners putting a higher gross amount into their own funds and it makes them feel more comfortable with those general partners.”

This uptrend in investors partnering with GPs of color is poised to continue, as increasing numbers of limited partners, such as pension funds, are allocating sizeable proportions of their investment dollars to diverse-owned private equity firms. For example, as of the end of Q3 2020, the Illinois State Board of Investment (ISBI) had $8.2B (nearly 40 percent of its total fund) allocated to emerging and minority-owned firms. Likewise, the Massachusetts Pension Reserve Investment Management (PRIM) set an objective of investing between 5 and 10 percent of all new and current investments with emerging and diverse-owned managers.

DIVERSE MANAGERS PAYING IT FORWARD

The receipt of carried interest is also crucial to the ability of private equity managers to invest in emerging managers of color and to contribute to philanthropic endeavors.

Managers of color, in particular, have a high propensity to do so. For example, GCM Grosvenor, a firm focused on global middle-market buyout investing, has investment and executive management teams comprised of 45 percent women and 40 percent people of color, respectively. It also boasts a highly visible small, emerging and diverse managers (SEDM) platform.

Derek Jones, the Managing Director of Private Equity Investments at GCM, explains that his focus on these groups “stems from our belief that with effective due diligence, SEDM managers represent a source of talent and opportunity. We have dedicated efforts to investing in small, emerging and diverse managers for more than 20 years, and such investments are a critical and vital part of our business and the value proposition to our clients. We serve as a strategic advisor to SEDM managers, providing knowledge transfer, and industry connectivity.”

Jones is proud of the SEDM initiative, not only because it provides excellent returns to the firm and its partners, but because “we believe there is a multiplier effect where SEDM managers that succeed hire diverse talent internally, often invest in diverse-owned businesses, prioritize staff and board diversity and invest in communities.”

Similarly, TPG, a global alternatives investment firm, started TPG NEXT to seed and support diverse asset managers. Justin Nunez, a Business Unit Partner in TPG Public Equity Partners, and Liz Stiverson, a Principal and Chief of Staff in TPG’s Executive Office, oversee the management of the initiative in partnership with a group of executive sponsors. Nunez explained that part of the impetus for the initiative was the recognition that the typical path to fundraising via friends and family – for fund managers and entrepreneurs alike - is less accessible to people of color. They believe there is a self-selecting bias in the industry that results in more limited networks and sourcing channels and disadvantages diverse talent. Most importantly, Nunez notes that the development of TPG NEXT was a business conversation; “we want access to the most interesting and compelling investment opportunities out there.”

Under a European waterfall structure, carried interest is calculated at the fund level across all deals. In this situation, the GP does not begin to take carried interest until the fund has returned all LP contributions across all deals and reached the designated hurdle rate. On the other hand, in an American waterfall, GPs may take a share of the carry based on the success of specific deals even if it is underperforming its hurdle rate, assuming the specific deals have outperformed the hurdle rate. It is important to note, however, that most funds that employ an American waterfall distribution include claw back provisions which allow limited partners to recoup the carry at the end of the fund’s life if the GP collected more than its share of the profits over the life of the fund.

TPG NEXT's first three investments include Harlem Capital, a diversity-focused venture capital firm; LandSpire Group, a 100 percent Black-owned real estate firm focused on investment and development in secondary markets across the United States; and VamosVentures, an early-stage venture firm investing in companies led by diverse teams, focused on the Latinx community.

This propensity to invest in building wealth in communities of color is also prominent in the philanthropic endeavors of fund managers of color. In 2016, Frank Baker, co-founder and managing partner at Siris Capital, and his wife Laura Day gifted $7 million to the University of Chicago to endow undergraduate scholarships and internships for lower-income students at the university. Mr. Baker also established a $1 million scholarship for Spelman College graduates. Likewise, Jose Feliciano, co-founder of Clearlake Capital group, and his wife provided $50 million in grants to minority-run investment companies through their Supercharged Initiative. Feliciano also gave $20 million to the couple's alma mater, Princeton University, and helped raise $10 million in hurricane relief for Puerto Rico. Similarly, Verdun Perry, Global Head of Blackstone Strategic Partners, gave $1 million for student scholarships at Morehouse College in 2020 and sits on the board of SEO and is a member of the Leadership Circle for the East Harlem Tutorial Program.

PRIVATE EQUITY INVESTMENTS IN MINORITY-OWNED BUSINESSES AND ENTREPRENEURS OF COLOR

BUSINESS WEALTH AND JOBS CREATED BY PRIVATE EQUITY

Many accounts of private equity inaccurately depict firms buying out businesses and aggressively cutting costs through massive layoffs. In reality, companies that receive private equity funding tend to experience significant growth in sales and employment over the first three years after financing, and often well after that.

"Diverse entrepreneurs outperform their peers by 33%, yet they remain invisible to traditional VC. This is a $4 trillion opportunity to invest in these entrepreneurs [and] get great returns for our investors"

- SHILA NIEVES BURNEY,
CEO AND GENERAL PARTNER AT ZANE VENTURE FUND

For example, one study found that companies financed by private equity experienced an additional 2 percent higher sales growth than comparable firms without such financing and that they experienced 14 percent greater jobs growth than control firms over the five years after financing.[viii] Among private equity firms focused on buyouts, transactions serve as catalysts for creative destruction such that the net employment decreases by less than one percent at target firms relative to controls in the first two years following buyouts.[ix] Aside from providing financial capital, private equity firms/investors help keep value-added strategies on track, broaden market focus and assess research and development.[x]

THE MUTUALLY BENEFICIAL RELATIONSHIP BETWEEN PRIVATE EQUITY AND MINORITY-OWNED BUSINESSES

Minority-owned businesses and entrepreneurs of color are in a position to decrease the vast racial wealth gap because of the relationship between business ownership, wealth, and wealth mobility across race. Black business owners, for example, have levels of wealth 12 times that of non-business owners, and the gap in the median wealth of white and Black business owners decreases to a factor of three.[xi] The growth of minority-owned businesses in the past decade has been considerable. According to the U.S. Senate Subcommittee on Small Business and Entrepreneurship, "over the last 10 years, minority business enterprises accounted for more than 50 percent of the two million new businesses started in the United States and created 4.7 million jobs. There are now more than four million minority-owned companies in the United States, with annual sales totaling close to $700 billion."[xii] Unfortunately, these businesses have persistently suffered from lending discrimination, making it difficult for them to build wealth, grow and develop an ecosystem that creates jobs and builds wealth within communities of color.[xiii]

Research consistently demonstrates, however, that minority-owned business enterprises (MBEs), especially Black and Hispanic businesses, have severely limited access to bank loans.[xiv] For example, research conducted by the Small Business Administration (SBA) shows that even once factors, such as credit score, net worth, size and legal form are controlled for, Black and Hispanic business owners were significantly less likely to have their loan applications approved compared to their white or Asian-American counterparts, both at startup and in later stages.[xv] Similarly, a review of loan application outcomes taken from the Federal Reserve's Survey of Small Business Finances (SSBF) found that 56 percent of Black-owned businesses and 63 percent of Hispanic-owned businesses were denied non-line-of-credit bank loans versus only 9 percent of white-owned businesses.[xvi]

Studies of bank lending discrimination also indicate that average loan size for minority-owned firms, controlling for firm-related factors including size and revenue, was 40 percent less than it was for white-owned firms. Minority-owned firms also pay significantly higher interest rates than do white-owned businesses.[xvii]

As a result of the lower levels of access to and less favorable terms of bank loans afforded businesses of color, they need to seek alternative sources of capital. Private equity firms have, like banks, historically been less likely to provide financing to minority-owned businesses. A study published in 2014 cites minorities as being 22 percent less likely than white people to receive private equity financing.[xviii] While this disparity is problematic, it indicates a stronger propensity for private equity fund managers to fund minority-owned businesses than banks. We are also witnessing a considerable uptick in both private equity and venture capital funding to Black entrepreneurs. Analysis from Crunchbase shows venture investment in Black entrepreneurs quadrupled to almost $1.8 billion through the first two quarters of 2021 relative to the same time period in 2020.[xvx]

What may partially account for this is an emerging class of business owners and entrepreneurs of color who bring even stronger abilities and qualifications to their ventures than their predecessors and white peers. Black business owners of employer-firms, for example, have substantially higher levels of education than do their white counterparts; while 31.2 percent of Black owners have graduate degrees, only 21.8 percent of white owners do. The emerging class of business owners also tend to be in higher-growth industries which may produce greater profits for investors.[xx] Recent research indicates that the average dollar invested into minority business enterprise portfolio companies by private equity funds yields higher returns ($1.45) relative to is the average dollar invested into white-owned portfolio companies ($1.14).[xxi] Likewise, VC funds focused on minority-owned businesses tend to see higher yields on their investments than funds without such a focus.[xxii]

Funds that target minority businesses therefore have the opportunity to earn strong returns on a largely untapped set of assets.

NON-WHITE FUND MANAGERS MORE LIKELY TO INVEST IN BUSINESSES OF COLOR

The increase in venture capital and private equity investment in minority-owned businesses is a crucial step in the right direction. It is imperative to recognize the disproportionate role that fund managers of color have and continue to play in this mechanism for wealth generation. Evidence from the Small Business Investment Company (SBIC) program run by the SBA, which makes capital available to private equity and venture funds (designated as SBICs) to provide equity and debt capital to small businesses, indicates that a significantly higher percent of investments made by SBICs with racially diverse investment teams go to MBEs than do those with all white investment teams. 12.7 percent of investments made by racially diverse SBICs go to companies led by minority CEOs and an additional 21.3 percent go to companies that are at least partly owned by people of color. In contrast, only 5.2 and 12.2 percent of investments made by white SBICs go to these types of businesses.[xxiii] Investing in minority owned businesses is profitable and investors of color are most likely to recognize and act on this fact.

Carried interest is a critical part of the equation in this case. As Derek Jones of GCM Grosvenor explains, “[c]arried interest enables smaller emerging fund sponsors to invest in diverse entrepreneurs, creating a ‘multiplier’ effect in terms of jobs, community impact and generation-changing wealth for underrepresented groups.”

CONCLUSION

Carried interest capital gains is a critical and growing source of wealth development among people and communities of color. It incentivizes and, in many ways, makes it possible for a growing number of underrepresented financial managers to serve as private equity and venture capital fund managers. These managers, in turn, are more likely to attract and employ additional professionals of color to this growing investment vehicle. With their share of the carried interest, managers of color are also able to fund initiatives for managers and entrepreneurs of color or engage in other philanthropic endeavors at a more impactful level.

The increase of diverse fund managers, coupled with the higher comfort level for risk within private equity and venture capital more broadly, increases the likelihood of business-owners of color receiving the capital they need to start and, equally importantly, grow their businesses, which is a major source of wealth and a generator of employment. A change in the treatment of carried interest would not only decrease the ability of fund managers of color to enter or stay in private equity, but it would result in the incapacity to rebuild the Black and Hispanic middle classes and deploy capital to marginalized communities that have consistently been overlooked by other demographics.

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In addition to her consulting and academic work, Dr. Beasley serves on the strategic board for Untapped, an impact-focused initiative that provides financial capital and strategic guidance to a network of entrepreneurs of color and is a member of the international advisory board for GlobalMindED. Interviews with and opinion pieces by Dr. Beasley regularly appear in major media outlets such as The New York Times, USA Today, Huffington Live, The Wall Street Journal, and NBC. She earned her A.B. from Harvard University and her Ph.D. in sociology from Stanford University.

The National Association of Investment Companies (NAIC) is the largest network of diverse-owned private equity firms and hedge funds. NAIC's membership consists of over 130 firms representing over $250 billion in assets under management (AUM). Through education, advocacy and industry events, the NAIC is focused on increasing the flow of capital to high-performing diverse investment managers often underutilized by institutional investors. Additionally, NAIC produces unique and compelling research on the performance of diverse managers and executes initiatives to strengthen and position the industry for future success.

The American Investment Council (AIC) is the leading advocacy and resource organization established to develop and provide information about the private investment industry and its contributions to the long-term growth of the U.S. economy and retirement security of American workers. Member firms of the AIC consist of the country's leading private equity and growth capital firms united by their successful partnerships with limited partners and American businesses.

ENDNOTES

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