Structure of the Fund. Private equity funds are generally organized as limited partnerships, with the investors as limited partners, or as similar entities that are treated as partnerships for tax purposes. For the sake of simplicity, this primer assumes that the fund being described is organized as a limited partnership. The fund's general partner is itself typically treated as a partnership for tax purposes, with individuals who are portfolio managers for the fund holding equity interests in the general partner. A partnership is not subject to U.S. federal income tax. Instead, a partnership's items of income, gain, loss and deduction are allocated to its partners, and the partners are generally treated as if they had derived their shares of those items directly. Importantly for the treatment of carried interest, the character of those items (including the character as ordinary income, short-term capital gain or long-term capital gain) is generally determined at the partnership level and flows through to the partners, including, in the case of a tiered partnership structure, such as a private equity fund and its general partner, through each tier to the ultimate taxpayers. Thus, the character of income, gains, losses and deductions recognized by a private equity fund is generally determined at the fund level.

Management Fee and Carried Interest. A private equity fund generally compensates its portfolio managers in two ways. First, it pays periodic management fees, the amount of which is determined without regard to whether the fund generates any profits. In many funds, the management fee is paid to a "management company" entity, often treated as a partnership for tax purposes, that is separate from the general partner of the fund. In addition to paying management fees, the fund grants its general partner a percentage interest in the fund's profits that is larger than the percentage of capital that the general partner contributes to the fund (the so-called "carried interest" because it is an interest in profits derived from, or "carried" by, the limited partners' capital contributions). Very generally, the carried interest is a percentage — often 20% — of the profits that would have been allocated to the limited partners if the fund had allocated all profits pro rata according to capital contributions.

The carried interest is part of the general partner's equity interest in the fund, entitling the general partner to allocations of a portion of the fund's profits. Therefore, under the principles described above, the character of the fund profits allocated to the general partner in respect of the carried interest flows through to the partners of the general partner. Typically, a significant portion of a private equity fund's profits consists of long-term capital gains. Under current law, individuals are subject to U.S. federal income tax on capital gains at rates that are substantially lower than the rates applicable to ordinary income (a maximum rate of 20% vs. a maximum rate of 39.6%). By contrast, the management fee constitutes ordinary income and, assuming that it is paid to a management company that is treated as a partnership for U.S. federal income tax purposes, it is subject to U.S. federal income tax in the hands of the individual partners of the management company at the 39.6% rate.