The Carried Interest Fairness Act of 2015

Frequently Asked Questions

The Carried Interest Fairness Act of 2015 provides that the "carried interest" compensation received by investment fund managers will be taxed at ordinary income rates and treated as wage income subject to employment taxes. In exchange for providing the service of managing their investors' assets, fund managers often take a portion of a fund's profits, or a carried interest, usually equal to 20 percent of such profits. The bill clarifies that this income is subject to ordinary income tax rates like all other income derived from labor rather than the much lower capital gains rate.

CARRIED INTEREST: THE BASICS

Why is Congress concerned about this issue?

Many investment funds are structured as partnerships in which investors become limited partners and the funds' managers are the general partner. The managers often take a considerable portion of their compensation for managing the funds' investments as a share of the funds' profits; this profits interest is often referred to as a "carried interest."

Partnership profits are not taxed at the partnership level; instead, partners are taxed on their share of partnership income. The character of that income (capital or ordinary) is determined at the partnership level and "flows-through" to the partners. Where a significant portion of an investment fund's profits are long-term capital gains, investment managers who are compensated with a carried interest are able to take advantage of the 20 percent long-term capital gains rate on income they receive for the performance of services. Essentially they are able to pay a lower tax rate than other Americans on income from their work simply because of the structure of their firm.

What does the legislation do?

It clarifies that any income received from a partnership, capital or otherwise, in compensation for services is ordinary income for tax purposes. As a result, managers of investment partnerships who receive a carried interest as compensation will pay ordinary income tax rates, rather than capital gains rates, on that compensation. The capital gains rate will continue to apply to the extent that a manager's allocation of capital gain income represents a return on capital they have actually invested in the partnership.

What kinds of investment firms will be affected?

This bill serves the broader goal of tax fairness. The principle at work is that compensation for services should be treated as ordinary income and taxed accordingly, regardless of its source. Any investment manager that takes a share of an investment fund's profits as its compensation (i.e., in the form of a carried interest), will be affected. This rule will apply to investment management firms without regard to the type of assets they manage, whether they are financial assets or real estate. The key issue is the form of compensation (i.e., a profits interest given for investment management services), not the type of assets the firm is managing, its investment strategy, or the amount of compensation involved.

What is "enterprise value" and how is it affected?

The basic goal of the carried interest legislation attempts to put fund managers in the same position as other working taxpayers by providing that net capital gain attributable to such managers' carried interest is taxed at ordinary income rates and subject to employment taxes. This has been the main thrust of all prior versions of carried interest legislation, including the version passed by the House, the version considered in the Senate, and, the administration's proposals. In drafting this bill, there has been further consideration of how to treat income recognized by a manager upon the sale of his interest (including his carried interest).

"Enterprise value" is a term that has been used to describe the increased value of the fund attributable to the fund's good track record or valued brand (i.e. goodwill). In some real world cases, a buyer might rationally pay more than liquidation value for the manager's interest. Since the introduction of the carried interest legislation, suggestions have been made to provide broad exemptions for enterprise value. One concern with such an approach would be that fund managers could potentially over-allocate the purchase price to enterprise value to get around the main purpose of the legislation and obtain a better tax result.

In response to previous concerns relating to enterprise value, provisions were first added to the Carried Interest Fairness Act of 2010 and have been carried through or modified in subsequent versions of the legislation. For instance, one provision provided that in certain circumstances, amounts recognized on the sale or exchange of a carried interest that are attributable to business intangibles (like goodwill) will retain its character as capital gains, and not be recharacterized as ordinary income – mirroring similar treatment that other businesses have under current law with respect to goodwill. Subsequent drafts modified the investment partnership rules for interests held in connection with a trade or business so that those interests would be appropriately characterized under the legislation. The current draft maintains that a taxpayer's failure to comply with the valuation regulations prescribed by the Secretary could result in the imposition of a 40-percent underpayment penalty to address the potential valuation and allocation issues mentioned above.

These modifications to the Carried Interest Fairness Act over time reflect continuing efforts by the bill sponsors to be sure of the right balance that would appropriately characterize enterprise value without violating the principal fairness goals of the Carried Interest Fairness Act of 2015.