The Carried Interest Fairness Act of 2012

Myths vs. Facts

Myth: Changing the tax treatment of carried interest is a tax increase on investment that will hurt economic growth.

Fact: Investors are not affected by this legislation at all.
Any person or institution who invests money in a fund whose managers receive a carried interest will continue to pay the capital gains rate on their profits. In fact, the bill explicitly protects the investments that fund managers make themselves. To the extent they have put their own money in the fund, managers still get capital gains treatment, but to the extent they are being compensated for managing the fund, they will have to pay ordinary income tax rates like other service providers. Since investors are not affected, there is no reason to believe that the amount of capital available for these kinds of investments will be reduced as a result of the bill.

Myth: Taxing carried interest is just about raising revenue.

Fact: Fairness requires treating all taxpayers who provide services the same.
This proposal would raise revenue, but it is not just an offset. Congress has a responsibility ensure that our tax code is fair, that it makes sense. A broad spectrum of experts, including the Chairman of the Cato Institute and senior economic advisors to the last three Republican Presidents, agree that carried interest really represents a performance based fee that investors are paying to fund managers and that it should be taxed accordingly. Allowing some service providers to pay the 15 percent capital gains rate on their income, when everyone else has to pay up to 35 percent, risks undermining people's confidence in our voluntary tax system.

Since this legislation was first introduced in 2007, a number of substantive and technical changes have been made that have reduced the revenue estimate of the bill. Where legitimate policy concerns have been expressed, the bill's sponsors have tried to address them, even if doing so reduced the revenue estimate.

Myth: Fund Managers are just like entrepreneurs who get founder's stock in their company, so they too should be taxed at the capital gains rate.

Fact: Fund Managers are fundamentally different than the founder of a company.
When someone starts an enterprise, he or she actually owns that business. Sometimes that business becomes enormously valuable, but quite often it fails altogether and the entrepreneur loses her business. When an investment partnership purchases an asset, be it a stake in a small start-up company, a large corporation that wants to go private, a portfolio of securities, or a piece of real estate, the partnership does truly own those assets. The general partner or fund manager though is really only an "owner" to the extent he or she has contributed capital to the partnership. The carried interest the general partner receives for managing the fund's assets is a right to a portion of the fund's profit, not to the fund's actual assets: the manager has no downside risk. If the fund fails completely and all of the partnership's assets are lost, the limited partners have lost their money. The manager has lost the time and energy he has put into the running the fund, and the potential to share in the profits, but he is not actually out of pocket.

In the separate case of the sale of manager's interest in an investment management firm, the Carried Interest Fairness Act has been reviewed and revised from previous versions to provide that where there is a clearly separable and verifiable element of goodwill, such as where there is a separate management entity, the manager will receive capital gains treatment for that portion of the gain on the sale. The goal is to ensure that all investment managers are treated in a manner consistent with other taxpayers who start and eventually sell a business, and work is ongoing in conjunction with the Joint Committee on Taxation to determine if that standard can be met in other cases.

Myth: Fund managers deserve capital gains treatment because a carried interest is risky.

Fact: Many other forms of compensation are risky, and they are all ordinary income.
When a company gives its CEO stock options, it is trying to give her an incentive to increase the company's share price, to growth the value of shareholders' investment. If the CEO does a good job and the share price goes up, she pays ordinary income tax rates when she exercises those options. Real estate agents only make money if they actually sell a house, no matter how hard they work. Authors receive a portion of their book's profits. Waiters get tips based on the quality of the service they provide. All of these people pay ordinary income tax rates on their compensation. Only private equity and other fund managers get to pay capital gains rates on their compensation.

Myth: Taxing carried interest will hurt the pension funds that invest in these funds.

Fact: This has nothing to do with pension funds and their returns will not be affected.
One pension trustee, who also happens to be a hedge fund manager, called the idea that this debate is about workers' pensions "ludicrous." As tax-exempt investors, pension funds certainly will not be affected directly, and the assumption that fund managers can charge higher fees than they do today as a result of their having to pay ordinary income rates is extremely questionable. In fact, an attorney representing the hedge fund industry testified before the Ways & Means Committee that investors would be unlikely to accept increased fees. The National Conference on Public Employee Retirement Systems has said that its members do not believe this legislation will affect them.

Myth: This change to the taxation of carried interest will harm every "mom and pop" partnership in America.

Fact: The change would only affect those partnerships where service income is being improperly converted to capital gains.
This legislation would have no effect whatsoever on the vast majority of partnerships that are engaged in ongoing businesses and whose profits are already being properly taxed an ordinary income tax rates. It does apply to investment fund partnerships where the investors in the fund choose to compensate the people managing their assets through a carried interest. In practice, this means hedge funds, private equity funds, venture capital funds and real estate partnerships. The reality is that the fund managers and general partners who would be asked to pay ordinary income tax rates on their compensation are a very small, very well-paid group of professionals. It is also important to note that the bill does not discriminate among partnerships based on the kind of investment assets they purchase.