# The Carried Interest Fairness Act of 2012

The Carried Interest Fairness Act 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 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 15 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 invested in the partnership.

In the 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.

**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.