NAR Issue Brief
Carried Interest

What is the issue and how is it treated under current law?

Many partnerships (including real estate partnerships) are organized with general partners, who contribute their expertise (and, in some cases, capital) and limited partners who contribute money and/or property (capital) to the enterprise. Generally, any profits of the partnership are divided among the limited partners. A common practice, however, is to provide additional incentive for the general partner to perform well by sharing some of the profits above a certain "hurdle" rate with him or her through a "carried interest," even when the general partner contributed little or no capital to the enterprise. The general partner's profits interest is "carried" with the property until the property is sold, which can be a number of years after the enterprise is formed and limited partners have received profit distributions.

During the time the property is held, the general partner receives compensation and fees that are taxed as ordinary income. The limited partners can receive both ordinary income from operations and capital gains from any profits generated during the year. When the property is sold, the limited partners receive their profits distribution (the earnings on the capital they invested) as capital gains. If the venture was successful, the general partner then also receives the value of any carried interest as capital gains income.

When and why was this provision put in the tax code?

The carried interest provision is not a specific provision of the tax law that was enacted in order to provide an incentive or tax benefit to general partners who receive carried interests. Rather, it is an integral product of the flexibility Congress imbued in the tax rules for partnerships more than 50 years ago. Under partnership taxation, each partner contributes his or her unique assets, and the partners have great flexibility to divide the gains in any way they deem appropriate. The current tax treatment of carried interests is based on the established partnership tax principle that partners are taxed based on their share of partnership income (ordinary or capital gains), rather than based on the character of the partner (general or limited) to whom the income is allocated. The partnership structure has been a huge success, giving investors and entrepreneurs in many industries the tools to create and grow businesses, build shopping centers, found technology companies, and create millions of jobs.

How much revenue would changing or eliminating this provision generate, and what would be the impact?

It is unclear how much revenue could be generated by changing the taxation of carried interests. Some tax policy experts believe that talented entrepreneurs would simply find other ways to structure new ventures to avoid the higher tax. Others argue that some deals that now make economic sense would simply not be done in the future, since a higher tax would increase the hurdle rate of return. Moreover, Congress itself seems torn on how to approach the issue, with some proponents of changing the tax rules urging that certain industries, such as real estate and venture capital, be exempt from the change. Such an approach would likely reduce any possible revenue raised by a significant amount. Others policy makers argue that the change should be made prospective only, which would also likely reduce any new revenue by a large amount.