

Client Alert

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Tax Department

Proposed Legislation Raises Taxes on Carried Interests for Investment Funds

Background

Managers in various types of partnerships, such as private equity and hedge funds, often share in the profits of the partnership through a so-called "carried interest." These interests generally allocate to such managers a percentage of the partnership's profits (often 20 percent), and such allocations are usually disproportionate in that the percentage of profits allocated to such managers are generally well in excess of the percentage of capital contributed by such managers to the partnership. Under current law, managers are generally not taxed upon the receipt of these interests, and managers who receive these interests are treated as partners in the partnership and hence their allocable share of partnership income, including the character of such income, flows through to such managers. Thus, to the extent that the partnership's profits constitute long-term capital gains, managers who are individuals are taxed on their allocable share of such capital gains at a maximum rate of 15 percent at the federal level.

Proposed Legislation

Pursuant to a bill introduced in the House of Representatives of the United States Congress by Representative Sander Levin on June 22, 2007, any net income earned with respect to

an "investment services partnership interest" would generally be treated as ordinary income. The bill accomplishes this by altering the usual flow-through treatment of partnership income so that any income that is allocated with respect to an "investment services partnership interest" is treated as ordinary income to the holder of such interest, regardless of the character of the income that is earned at the partnership level. The bill contains similar rules for treating gain on the disposition of such an interest as ordinary income, and also treats the distribution of appreciated property with respect to such an interest as triggering gain as if the partnership had sold such distributed property at fair market value. In addition, the bill generally limits net losses with respect to such interests to the extent of aggregate net income that has been realized with respect to such interests in prior years (less prior allowed losses).

An "investment services partnership interest" is defined as any partnership interest held by a person who provides (directly or indirectly), in the active conduct of a trade or business, certain investment-type services to the partnership with respect to "specified assets". The bill defines "specified assets" to mean securities, real estate, commodities, or options or derivative contracts with respect to such assets. The investment-type services implicated by this provision include (i) advising on

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the value of, the investment in, or the purchase or sale of, any specified asset, (ii) managing, acquiring or disposing of any specified asset and (iii) arranging financing with respect to acquiring specified assets.

The bill provides that the ordinary income recharacterization rules described above do not apply to the portion of an investment services partnership interest that is acquired through the contribution of capital (provided that the allocation of

partnership items to the portion of the partnership interest that is attributable to contributed capital is reasonable).

The bill does not contain an effective date, and its ultimate passage is uncertain at this time. However, the bill would in many cases reverse the flow-through tax treatment that is currently accorded to partnership interests that have been granted to managers of investment partnerships, and thus the effect of such legislation would be significant.

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