

CLIENT ALERT

Taxation of Carried Interest Continues To Be Under Scrutiny In Washington

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By adding Section 1061 to the Internal Revenue Code of 1986, the Tax Cuts and Jobs Act of 2017 altered the taxation of carried interest. Typically, the general partner of an alternative asset fund, such as a private equity or hedge fund, is granted an interest in the partnership that entitles it to a portion of the profits earned in the future. Prior to the enactment of Section 1061, if the general partner was allocated long-term capital gains from the sale of partnership property held for at least one year with respect to its carried interest, it (or, if the general partner is itself a partnership, its partners) would pay taxes on these gains at preferential capital gains rates. However, after the enactment of Section 1061, the general partner (or its equity owners) will only be entitled to the preferential long-term capital gains rates if the partnership property that generated the capital gain was held for at least three years.

Before the passage of Section 1061, the tax treatment of carried interest was the subject of robust debate, with annual proposals for reform predominately, but not exclusively, from the Obama administration and Democratic lawmakers. The enactment of Section 1061 has not ended this debate. The taxation of carried interest continues to be an area of scrutiny and potential legislative activity. President Trump recently reiterated his desire to restructure the taxation of carried interest. Additionally, on May 23rd, Senate Finance Committee Ranking Member Sen. Ron Wyden (D-OR) proposed legislation to further change the taxation of a carried interest. While President Trump does not have a specific carried interest proposal, Sen. Wyden's proposal would generally treat a recipient of a carried interest as receiving a loan from the underlying fund, which is used to acquire the carried interest, and would subject the recipient to tax at ordinary income rates based on an amount of interest that is deemed to be forgiven with respect to such loan.

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The legislative path to further changes of the taxation of carried interest is challenging, but additional changes that negatively impact carried interest recipients are possible. Proponents of the current tax treatment of carried interest continue to argue that private capital investment is essential to economic growth and job creation, and is a vital and fundamentally entrepreneurial part of the U.S. economy. Opponents counter that alternative asset managers are simply providing services while being taxed at rates that are appropriate only for the providers of capital. How this debate will ultimately be settled is uncertain, but it appears that for the near future, significant changes to the taxation of carried interest are not likely. We will continue to monitor any pending legislation and provide updates on additional developments.

If you have any questions regarding this client alert, please contact the following attorney or the Willkie attorney with whom you regularly work.

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