NEWLY PROPOSED LEGISLATION WOULD TAX CARRIED INTEREST EARNED BY INVESTMENT FUND MANAGERS AT ORDINARY INCOME RATES

On June 22, 2007, Congressman Sander Levin (D-MI), along with several other members of Congress including Charles Rangel (D-NY) and Barney Frank (D-MA), introduced legislation to change the tax treatment of sponsors of investment partnerships (including private equity, real estate, venture capital and hedge funds) that receive a share of partnership profit for services performed for the partnership. The right to receive such profit is commonly called a "carried interest." The bill would tax amounts recognized in respect of such interest as ordinary income (currently subject to a maximum rate of 35%) and not long-term capital gain (currently subject to a maximum rate of 15% in the case of individuals) even if derived from the sale of a capital asset.

Under current law, a partnership's income and gain, including long-term capital gain, retains its character when allocated to its partners, even if the allocation is received for services. Gain on a partnership interest is generally taxed as capital gain. The legislation would generally treat net income allocated in respect of an "investment services partnership interest," and gain from the sale of such interest, as ordinary income received for the performance of services. Net losses with respect to such an interest would be allowed only to the extent of prior net income less previously allowed losses. The provision would not change the timing of the income and gain recognition or affect the tax treatment of other partners.

The bill generally defines an "investment services partnership interest" as any interest in a partnership held by a person that directly or indirectly provides, in the active conduct of a trade or business, a substantial quantity of any of the following services to the partnership: advising the partnership as to the value of a specified asset or the advisability of investing in, purchasing, or selling a specified asset; managing, acquiring, or disposing of a specified asset; arranging financing with respect to acquiring specified assets; and performing services supporting the foregoing. It defines "specified assets" as securities (generally stock, debt and interests in widely held or publicly traded partnerships or trusts but not other types of partnerships or trusts), real estate, commodities and options or derivatives with respect to those assets. Therefore, the bill would not change the taxation of a carried interest or other allocation received for services provided to most kinds of operating partnerships.

In addition to affecting the applicable rate of tax, the recharacterization of income and gain under the bill would have other potential consequences to many different types of taxpayers and transactions. Some of these are clearly intended; others are not.

- *Qualifying income under the publicly traded partnership rules*. The bill, like the so-called Blackstone bill recently introduced in the Senate, is intended to prevent publicly traded partnerships engaging in an investment advisory business from being taxed as partnerships. However, while the Senate bill would preclude partnership treatment if any

income comes from these services, the House bill would simply treat this income as nonqualifying under the test that requires 90% of the partnership's income to be qualifying for partnership treatment to be available to a publicly traded partnership.

- *U.S. trade or business income*. Although not explicitly stated, the bill also appears to treat income recharacterized under the measure as subject to regular net-based U.S. federal income taxation to the extent allocable to foreign investors if the relevant services are performed in the United States. Under current law, foreign investors in a partnership are generally not subject to U.S. taxation on partnership income to the extent attributable to gain, non-U.S.-source income and certain types of U.S.-source interest income. If enacted, the bill would likely discourage non-U.S. persons from investing in advisory businesses receiving a carried interest, limiting this increasingly common source of capital for these businesses.
- *Unrelated business taxable income*. It is unclear whether the bill is also intended to treat income and gain recharacterized under the provision as unrelated business taxable income ("UBTI") and thus subject to tax in the hands of otherwise tax exempt investors. Most investment income, unless debt-financed, is not UBTI. Again, such a provision likely would discourage tax-exempt investors from investing in advisory businesses receiving a carried interest.
- *Investment vehicles with subordinated and preferred partnership interests*. Many investment vehicles are structured as partnerships with preferred and subordinated interests where some members provide advisory-like services to the partnership. (For example, family investment partnerships and trusts designed to create short-term municipal paper rely on these structures.) The intended and actual effect of the legislation, if enacted in its current form, on these structures is unclear, but it would seem potentially to apply if a member provides substantial services as part of an active trade or business.

The bill explicitly does not recharacterize income and gain for purposes of determining whether a fund meets the requirements for qualifying as a real estate investment trust (a "REIT"). However, any recharacterized income would be treated as ordinary income to the REIT shareholders when distributed to them.

Finally, any income or gain recharacterized under the bill would be subject to the 2.90% Medicare tax, which is uncapped, as well as the 12.40% Old Age, Survivors, and Disability Insurance tax (also known as the Social Security tax), which is capped at $12,090. Under current law, this income is generally not subject to these employment taxes.

If a partner acquires a portion of an investment services partnership interest on account of a contribution of invested capital, the income or gain attributable to such contribution would not be recharacterized under the bill. However, the portion of the allocation treated as attributable to a capital contribution cannot be greater than the portion of income that would have been allocated with respect to the same amount of invested capital contributed by a partner not providing services. The bill appears not to aggregate affiliates for purposes of these determinations.

The bill also does not change the tax treatment of stock (including deeply subordinated stock that functions economically like a carried interest) or other forms of property received for services. Depending on the circumstances, recharacterizing such income as compensation could actually lower total taxes paid when the income results in a corresponding compensation deduction.

There is no indication in the legislation as to the effective date for the provision.

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