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# Closing in on Taxation of Carried Interest

The movement to treat "carried interest" as compensation income continues to gather momentum. Representative Sander Levin (D-Mich.) recently reintroduced legislation reclassifying carried interest earned by investment fund managers as compensation income subject to ordinary income rates (currently taxed federally at up to 35% and possibly increasing to 39.6% in 2011) rather than capital gains rates (currently taxed federally at 15% and possibly increasing to 20% in 2011).

Similarly, President Obama's proposed budget for fiscal year 2010 relies in part on increased tax revenues (beginning in 2011) from the taxation of carried interest at ordinary income rates. Although the proposed budget does not include any details on the change in law for carried interest (other than the revenue amounts expected to be generated), Representative Levin's bill does provide some insight into the likely structure of the law change. The recent bill is similar to the carried interest legislation introduced in October 2007 that did not make it through Congress. See our earlier "Client Advisory - Congress Begins Move Against General Partners' Carried Interests," dated June 25, 2007, for an initial discussion on this topic. However, given the current budget deficits, the number of new expensive spending initiatives proposed by the President, and the current economic and political climates, there may be more support for the current proposals.

The recent bill (like its predecessor) applies to partnership interests (including membership interests in LLC's taxed as partnerships) that are held by persons who are providing a "substantial quantity" of specified services (such as advisory or management services and arranging financing) with respect to specified assets. "Specified assets" include securities, real estate held for rental or investment, partnership interests and commodities (and any options or derivative contracts with respect thereto). Accordingly, the bill would apply to typical carried interest arrangements with general partners of venture capital, private equity, real estate, hedge or other alternative investment funds. As drafted, the bill would also impose ordinary income treatment on any gain realized upon a disposition of a covered interest. The bill would not apply to the portion of an otherwise covered interest that is acquired in return for a contribution of capital (or in respect of undistributed earnings).

The legislative description of the bill claims that it is not intended to change the general tax treatment of "profits interests" that are often issued to employees or other service providers of operating companies that are engaged in ongoing businesses. However, the language of the proposed bill is very broad and it does apply to any interest received in return for advisory or management services. As a result, certain "profits interests" issued in companies not typically regarded as "investment funds" but nonetheless holding "specified assets" (for example, small real estate partnerships) may be captured by the current wording of the bill.

The bill includes provisions designed to prevent the use of alternative fund structures to avoid the application of the new law (such as the use of loans to fund contributions to capital).

The bill is currently silent as to the effective date. The President's budget, however, does not reflect any revenue from the change until 2011, implying that the change is not expected to apply in 2009-2010. This would be consistent with the President's current stated goal of avoiding any tax increases in 2009-2010 so as not to interfere with the economic recovery. The new law would apply to any income allocated after the effective date regardless of when the partnership interest was issued or acquired.

We will continue to closely monitor this issue and will provide future client updates. Please contact one of the tax partners below if you have any questions.

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