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Client Advisory / *June 25, 2007*

Congress Begins Move Against General Partners' Carried Interests

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Investment fund managers may be forced to pay higher tax rates on income from their investment funds if a bill introduced in the House of Representatives on Friday, June 22, 2007 becomes law. The bill (H.R. 2834) would cause income received in respect of certain "carried interests" in partnerships to be taxed as ordinary income.[1] Currently, such income retains its character realized at the partnership level, which is often capital gain. This change would likely increase the federal income tax on income from a carried interest from 15% to 35%. See our earlier "Client Advisory – General Partners' Carried Interest May Be Congress' Next Tax Target," dated March 12, 2007, for an initial discussion of this topic.

The bill applies generally to any partnership interest received with respect to the provision of specified advisory or management services relating to partnership investments in securities, real estate, or commodities (or options or derivatives thereon). Accordingly, it would apply to most typical carried interests held by general partners in venture capital, private equity, real estate, or hedge funds. Ordinary income treatment would also apply to any gain recognized on the disposition of a covered interest. The bill's provisions, however, would not apply to the portion of an otherwise covered interest that is acquired on account of the contribution of invested capital. Thus, general partners' non-carried portion of their interests would not be adversely impacted by this bill.

The language of the proposed bill is very broad, and it goes beyond simply taxing covered carried interest income at ordinary income rates. The bill states that any net income with respect to a covered partnership interest is treated as ordinary income "for the performance of services." Thus, in addition to taxing this income at ordinary income rates, the bill appears to exclude such income from passive income treatment under provisions such as the publicly traded partnership rules (the recent "Blackstone Group" issue). As a result, if more than 10% of a publicly traded partnership's income comes from a carried interest covered by the bill, it appears that the partnership would be taxed as a corporation. Also, characterization of such income as being for the performance of services raises the possibility that it may be subject to employment-related taxes (for example, the 2.9% Medicare tax).

In addition, as mentioned above, the bill applies to any partnership interest received by a person as a result of the provision of covered advisory or management services to a partnership. Accordingly, certain carried interests or other "profits" interests in partnerships not typically regarded as "investment funds" but holding covered investment assets (for example, a small real estate partnership) may be covered by the bill.[2]

The bill is currently silent as to its proposed effective date, thus it is not possible to determine at this time whether any aspect of the proposal will apply to existing carried interests. It is anticipated that the effective date provisions will be fashioned as the legislation is debated.

Hearings on the issues covered by the bill are expected to follow Congress's July 4th recess.

[1] The bill's sponsors include Representative Sander Levin, Ways and Means Committee Chairman Charles Rangel, and House Financial Services Committee Chairman Barney Frank.

[2] Profits interests in partnerships with active business operations should not be covered by the bill.

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