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New Proposed Legislation to Tax Income Derived From "Carried" Partnership Interests as Ordinary Income

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On Friday, June 22, 2007, Rep. Sander Levin (D – Mich), introduced a bill (the "Bill") to tax income earned by investment fund managers from "carried" partnership interests as ordinary income. The Bill was co-sponsored by, among others, House Ways and Means Committee Chairman Charles Rangel (D – N.Y.), and is aimed at individual partners in a partnership (such as a typical domestic private equity fund) who derive income from a partnership interest in exchange for certain investment management services.

Background

In February, reports began surfacing that the Senate Finance Committee was examining the federal income tax treatment of "carried" partnership interests. In general, most domestic investment funds (like private equity or hedge funds) are formed as partnerships for federal income tax purposes. The service partner, typically the general partner ("GP") who manages the investment partnership, is usually compensated in two ways: a management fee equal to a specified percentage (e.g., 2%) of capital commitments per annum and the "carried" interest equal to a specified percentage (e.g., 20%) of realized gains. The "carried" interest is generally structured as a profits interest in the investment partnership and represents the right to share in appreciation of fund investments when such appreciation is realized by the partnership. The GP generally will include income derived from his or her "carried" interest as capital gains taxable at favorable capital gains rates to the extent that it represents a share of long-term capital gains realized by the partnership[1]. In the case of individuals, long-term capital gains are generally taxed at a maximum 15% rate under current law, whereas ordinary income is taxed at a maximum rate of 35%.

In May, Senate Finance Committee Chair Max Baucus said that the Senate Finance Committee's study of the federal income tax treatment of "carried" interests was in the early stages and no "proposal" was in the works.[2] However, just a month later, Democratic members of the House of Representatives introduced the Bill.

It should be noted that the Bill was introduced nine days after Senators Baucus and Charles Grassley, the Senate Finance Committee's ranking member, introduced another bill designed to stop private equity firms and hedge fund advisors from going public as publicly traded partnerships while continuing to be treated as partnerships for federal income tax purposes.[3] Given recent public comments by members of Congress about their concern over the federal income tax treatment of "carried" interests, and the recent public offering of firms such as Blackstone Group, L.P., the timing of the Bill is not surprising.

Summary of the Bill

The Bill would add new Section 710 to the Internal Revenue Code of 1986, as amended (the "Code"). Section 710 would provide that net income derived from, and gain on the disposition of, an investment services partnership interest ("ISPI") would be treated as ordinary income for the performance of services. Net loss from an ISPI would be treated as an ordinary loss. An ISPI is broadly defined as any partnership interest (capital or profits) held by a person who, in the conduct of an active trade or business, provides a substantial quantity of certain investment management services, including: (i) advising the partnership as to asset valuation, (ii) advising the partnership as to purchasing or selling assets, (iii) managing, acquiring, or disposing of assets, (iv) arranging financing with respect to asset acquisitions, and (v) any supporting activity related to these services. Thus, any partner in a partnership who provides the requisite type of investment management services could be affected by the Bill, if such partner receives his or her partnership interest (capital or profits or both) in exchange for those services.

The Bill also defines the type of assets with respect to which a partner would need to provide investment management services in order to be affected by the Bill. This definition includes stock, interests in publicly traded partnerships or trusts, debt, various derivatives, and commodities.[4] It also includes real estate. Thus, real estate partnerships are not excluded from the scope of the Bill. However, the Bill includes a special carve-out rule for real estate investment trusts ("REITs") and does not affect an entity's ability to qualify as a REIT. Although it is not clear that a REIT can receive a "carried" interest, if the REIT receives a "carried" interest from a real estate partnership, the Bill would not recharacterize as ordinary income the income from such "carried interest" for purposes of the REIT's 95% and 75% gross income tests. Nevertheless, such income would flow through to the REIT's shareholder as REIT dividends taxed as ordinary income.

To prevent taxpayers from circumventing the provisions of the Bill, the Bill also provides that gain from the distribution of appreciated property with respect to an ISPI shall be recognized by the partnership as if such property was sold by the partnership at fair market value at the time of distribution. This provision would override the general rule that the distribution of appreciated property with respect to a partnership interest is not a taxable event.

Finally, to the extent the investment fund manager also has capital actually invested in the investment partnership from which he or she earns the "carried" interest, the Bill does not affect the tax treatment of the portion of the investment fund manager's partnership interest that represents capital actually invested. The capital gains rate would continue to apply to the extent of the investment fund manager's income and gain represented by a reasonable return on invested capital. A reasonable return on invested capital would not include any amount allocated to the service providing partner in excess of what non-service providing partners are allocated as a return on their invested capital.

A House Ways and Means Committee press release accompanying the Bill states that a publicly traded partnership which receives more than 10% of its income from a carried interest covered by the Bill would be taxed as a corporation for federal income tax purposes.[5] However, this provision is not in the text of the Bill.

There is no effective date provided in the Bill. According to the Bill's sponsors, that will be decided in the legislative process. In this regard, Representative Rangel has announced that the House Ways and Means Committee will hold hearings on the federal income tax treatment of carried interests, related matters and "tax fairness" in July.

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Footnotes:

[1] For a more complete description of a typical "carried" interest, *see* Morrison & Foerster LLP Legal Update, The Current Debate About the Federal Income Tax Treatment of "Carried" Interests – Status and Possible Approaches (April 13, 2007) *available at* http://www.mofo.com/news/updates/files/12183.html.

[2] *Id.*

[3] Morrison & Foerster LLP Legal Update, New Proposed Legislation Would Tax Certain Publicly Traded Partnerships as Corporations (June 21, 2007) *available at* http://www.mofo.com/news/updates/files/12458.html.

[4] Specifically, the applicable assets include (i) stock, (ii) partnership or other beneficial interests in publicly traded partnerships or trusts, (iii) debt, (iv) interest rate, currency, or equity swaps, (v) real estate, (vi) commodities, and (vii) options or derivative contracts with respect to any of the

foregoing.

[5] Press Release, House Committee on Ways and Means, Investment Management Services Taxation (June 22, 2007) *available at* http://waysandmeans.house.gov/media/pdf/110/factsheet.pdf.