

Client Alert

A report
for clients
and friends
of the Firm June 2007

Congress Takes Formal Steps To Tax Carried Interest as Ordinary Income

On Friday, June 22, U.S. Representative Sander Levin (D-MI), together with more than a dozen other members of the House of Representatives, introduced a bill to tax as ordinary income those profits, referred to as "carried interest," earned by investment fund managers. The message from those sponsoring the bill is that they view carried interest as akin to compensation income and, as a result, they believe it should be taxed at the same rates applicable to services income earned by other U.S. service providers.

Under current law, the tax character of carried interest is determined at the partnership level based on the character of partnership income, so that carried interest is typically taxed at long-term capital gains rates. The bill, if enacted, would have broad sweeping effects on the structure of investment funds, and would represent a sea change in the private investment funds industry. At this stage of the legislative process, however, we believe that it would be premature to engage in restructuring efforts in response to the bill.

The following is a more detailed summary of the current bill.

Overview

The bill creates a new class of interests in a partnership referred to as "investment services partnership interests" or "ISP Interests." Under the bill, among other things,

(1) any net income allocated by a partnership to the holder of an ISP Interest would be treated as ordinary income;

(2) any net loss allocated by a partnership to the holder of an ISP Interest would be treated as ordinary loss;

(3) gain or loss from the sale (or redemption) of an ISP Interest would be treated as ordinary income or loss;

(4) distributions of appreciated property "with respect to an ISP Interest" would be taxable as if the property were sold for fair market value (under current law, distributions in kind are generally not taxable); and

(5) all net income treated as ordinary income also would be subject to employment taxes.

A separate provision of the bill provides that ordinary losses in respect of an ISP Interest may be used only to the extent of previously recognized ordinary income in respect of such interest. Any amounts disallowed would be carried forward for potential use in subsequent years, substantially limiting any benefit that otherwise could be obtained as a result of the loss recharacterization.

ISP Interests

An ISP Interest is defined as any interest in a partnership which is held by any person if such person provides (directly or indirectly), in the active conduct of a trade or business, a substantial quantity of certain services to the partnership.

These services include (1) advising the partnership as to the value of any "specified asset," or the advisability of investing in, purchasing or selling any specified asset, (2) managing, acquiring or disposing of any specified asset, (3) arranging financing with respect to acquiring specified assets, or (4) any activity in support of any of the preceding services.

For this purpose, a specified asset includes securities, real estate and commodities, as well as options or

derivative contracts with respect to the foregoing. “Securities” and “commodities” are broadly defined to include debt and equity securities, commodities and certain related derivative instruments. The bill does not provide any guidance for the scope of its application to real estate, although the bill does provide that the income recharacterization rules will not affect an entity’s eligibility to be taxed as a “real estate investment trust.”

Exception for Invested Capital

The bill includes a specific exception for the portion of an ISP Interest that is acquired on account of a contribution of invested capital. Under the bill, invested capital means the fair market value – at the time of contribution – of any money or other property contributed to the partnership. This exception only applies, however, if the partnership makes a “reasonable allocation” of partnership items between the ISP Interest that is with respect to invested capital and the portion of the ISP Interest that is not with respect to the invested capital.

Although there is no stated safe harbor for determining allocations that would be treated as reasonable, the bill does provide that an allocation will not be treated as reasonable if the allocation would result in the partnership allocating a greater portion of income to invested capital than any other partner not providing services would have been allocated with respect to the same amount of invested capital. Because invested capital is determined by reference to the fair market value of property contributed, the strategy frequently used by investment firms by which management fees payable to the managers are reduced in exchange for the managers receiving an additional interest in partnership profits would no longer be effective.

Impact on Publicly Traded Partnerships

A publicly traded partnership is generally taxed as a corporation, unless 90% or more of the partnership’s income is “qualifying income.” Qualifying income includes interest, dividends and capital gains. Under the press release accompanying the bill, amounts recharacterized as ordinary income would not be treated as qualifying income, thereby substantially reducing the possibility for a publicly traded investment firm to be taxed as a partnership.

Effective Date

The bill does not provide an express effective date nor does it include a “grandfathering” provision (to prevent its application to existing partnerships) or a phase-in period.

Observations

The scope of the bill is extremely broad. In certain areas, the bill is also comprehensive in detail and thoroughness. Nonetheless, the bill leaves many technical questions unanswered, such as:

- Would carried interest held by a non-U.S. person be taxable in the U.S.?
- Would carried interest held by a tax-exempt entity be treated as “unrelated business taxable income” that is taxable to such entity?
- How would the recharacterization rules apply for income realized in the current year?
- How would the loss disallowance rules apply for capital losses that otherwise would be allocated to reverse-out prior allocations of capital gain?
- The bill treats a distribution of appreciated property “with respect to an ISP Interest” as a taxable transaction, but does not clarify what it means for a distribution to be made with respect to an ISP Interest. Would the provision apply if the gain from that distribution otherwise would be allocated to an interest that is not an ISP Interest?
- The bill specifically includes services related to real estate, but does not provide further guidance on this point. For example, does it apply to real estate-related activities, such as oil and gas, timber or other such funds?
- The determination of whether an interest in a partnership is an ISP Interest is made by reference to whether the holder of the partnership interest performs, directly or indirectly, a substantial quantity of certain services. Neither “directly or indirectly” nor “substantial quantity” is defined.
- The “active trade or business” requirement seems at odds with the description of “services.” Under existing federal income tax law, investing in stock and securities generally is not treated as a trade or business for most purposes of the tax code. The definition of services in the bill, however, seems limited to such investing activities.

Going Forward

Although the bill apparently has broad support from several leading Democratic members of the House, including Ways and Means Committee Chairman Rangel, the bill is still far from becoming law. The legislative process includes public hearings (which we understand will be scheduled for early July), review and approval by the House Ways and Means Committee, and then deliberation and vote by the full House of Representatives. Legislation would follow a similar process in the Senate. In most cases, differences in the House and Senate versions of the legislation would require resolution by a conference committee and the revised

conference bill would then be subject to another vote by the House and the Senate. If approved by the House and the Senate, the revised bill would then be submitted to the President for signature or veto.

We have been working with the National Venture Capital Association in connection with their lobbying efforts on this matter, and will keep you apprised of further developments.

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If you would like to further discuss the bill, or its implications on your activities, please contact a member of the Tax Practice Group.

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Mary B. Kuusisto

617.526.9760 – mkuusisto@proskauer.com

Arnold P. May

617.526.9757 – amay@proskauer.com

Stuart L. Rosow

212.969.3150 – srosow@proskauer.com

Amanda H. Nussbaum

212.969.3642 – anussbaum@proskauer.com

Raj Tanden

310.284.4567 – rtanden@proskauer.com

Scott S. Jones

617.526.9772 – sjones@proskauer.com

Jamie E. Poindexter

617.526.9773 – jpoindexter@proskauer.com

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