



## Congress Proposes to Increase Fund Managers' Taxes on Carried Interests

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On June 22, 2007, Representative Sander Levin (D-MI) introduced legislation ([H.R. 2834](#)) to treat income received by partners performing investment management services as ordinary income received for the performance of services. The proposed legislation (co-sponsored by, among others, Ways and Means Committee chairman Charles Rangel (D-NY) and Financial Services Committee chairman Barney Frank (D-MA)) is part of the larger debate regarding the taxation of private equity funds, hedge funds and other investment funds and their "carried interests," the arrangements under which the fund managers share in the investment profits generated by the funds they manage. Currently, the character of the managers' income from a carried interest "flows through" from the underlying investment fund and, accordingly, a large part of the managers' income from the fund is eligible for favorable long-term capital gain treatment. For a description of the taxation of carried interests under existing law, including Treasury Department proposed regulations on the topic, see our [December 2005 Partnership Tax Bulletin, Treasury Revisits Guidance on Partnership Interests Exchanged for Services](#).

The carried interest legislation followed on the heels of narrower legislation ([S. 1624](#)) introduced on June 14, 2007 by Senators Max Baucus (D-MT) and Chuck Grassley (R-IA), chairman and ranking minority member, respectively, of the Senate Finance Committee, to change the taxation of publicly traded, investment fund management companies. Comparable legislation ([H.R. 2785](#)), but without any transition relief, was subsequently introduced in the House by Representative Peter Welch (D-VT). The Senate Finance Committee held a hearing on carried interests on July 11 and July 31, 2007.

### Pillsbury's Federal Tax Controversy and Tax Policy Team

Our Federal Tax Controversy and Tax Policy Team, headed by [Eileen J. O'Connor](#), former Assistant Attorney General for the Department of Justice's Tax Division, has been monitoring legislative developments in this area. The issues under discussion in addition to carried interests and the publicly traded partnership rules include the use of offshore, tax-haven corporations, for example, to shield U.S. tax-exempt organizations (primarily pension funds and university endowments)

from U.S. tax on their leveraged investment gains under the debt-financed property provisions of the unrelated business income tax rules.

Pillsbury's tax attorneys work closely with our public policy lawyers to help our clients analyze the impact of proposed tax legislation on their businesses and to advance changes in the law or amendments to pending legislation. Such endeavors often are successful in solving a client's problem and avoiding adverse tax consequences. Once a law is passed, we can represent a client's interest in achieving a favorable interpretation of the law as regulations are drafted by the Treasury Department.

Our attorneys combine an understanding of the substance of complex tax law and policy with the knowledge of related Congressional and executive branch processes. Also, we are familiar with the policy-makers who are at the center of the legislative and regulatory activity. Our lawyers are capable of drafting legislation and devising strategies, including forming coalitions with other like-minded parties, to gain the political support necessary to maximize political leverage to achieve a successful outcome. All of our lawyers who practice in this area have gained "real world" professional experience working for members of Congress and in various federal departments and agencies, including the Treasury Department and the Internal Revenue Service. One member of our public policy team served on the Ways and Means Committee while he was a member of the United States House of Representatives.

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## Proposed Legislation

### *Carried Interests*

The Levin bill would add new section 710 to the Internal Revenue Code providing that any net income from an “investment services partnership interest” is treated as ordinary income for the performance of services. Any net loss from such an interest is treated as an ordinary loss but is allowable for any partnership taxable year only to the extent it does not exceed the excess, if any, of the aggregate net income for such interest for all prior partnership taxable years over the aggregate allowable net loss for such interest for all prior partnership taxable years. Any disallowed loss is carried forward to subsequent partnership taxable years.

New Internal Revenue Code section 710 would also treat any gain on the disposition of an investment services partnership interest as ordinary income for the performance of services. In addition, a partnership would be required to recognize gain on the distribution of any appreciated property with respect to any investment services partnership interest, as if the appreciated property had been sold by the partnership for its fair market value. Finally, the Levin bill would subject the amounts treated as ordinary income under new section 710 to the self-employment tax.

An investment services partnership interest would be defined as any interest in a partnership held by any person if such person provides (directly or indirectly), 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 any specified asset,
- advising the partnership as to the advisability of investing in, purchasing or sell any specified asset,
- managing, acquiring or disposing of any specified asset,
- arranging financing with respect to acquiring specified assets or
- any activity in support of any of the foregoing services.

A “specified asset” means:

- securities (as defined in section 475(c)(2)),
- real estate,

- commodities (as defined in section 475(e)(2)) or
- options or derivative contracts with respect to the foregoing.

The income recharacterization rule does not apply to any reasonable allocation of partnership income to that portion of an investment services partnership interest that is acquired on account of a contribution of investment capital. An allocation is not reasonable if it results in the holder of the investment services partnership interest receiving an allocation of a greater portion of income to invested capital than any other partner not providing services.

Interestingly, the Levin bill as introduced does not contain an effective date.

### *Publicly Traded Partnerships*

Most publicly traded partnerships are taxed as corporations. Under existing law (section 7704(c)), this rule does not apply to a publicly traded partnership for any taxable year for which at least 90 percent of the partnership’s income is “qualifying income” (defined in section 7704(d) but generally comprised of passive income). Under both the Baucus-Grassley and Welch bills, that exception would not apply to any partnership that has any item of income or gain (including capital gains or dividends) the rights to which are derived from:

- services provided by any person as an investment adviser (as defined in section 202(a)(11) of the Investment Advisers Act of 1940 (the “Act”)) or as a person associated with an investment adviser (as defined in section 202(a)(17) of the Act) or
- asset management services provided by any such person in connection with the management of assets with respect to which such investment advisory services were provided.

Accordingly, any investment fund management company going public would generally become taxable as a corporation.

Both the Baucus-Grassley and Welch bills would apply to taxable years of a partnership beginning of or after their dates of introduction (June 14, 2007 and June 20, 2007, respectively). However, the Baucus-Grassley bill delays this effective date for five years for any partnership that was publicly traded on June 14, 2007 or that had filed on or before June 14, 2007 a registration statement with the Securities and Exchange Commission necessitated

solely by reason of an initial public offering of interests in the partnership. The Welch bill contains no such transition relief.

#### Material Available On-Line

The following legislative material can be retrieved using the links below. Alternatively, that material is available and has the indicated file name at ftp.pmtax.com/part.

- [H.R. 2834](#), the Levin carried interest bill [hr2834\_070622.pdf, 50K].
- *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests*, prepared by the staff of the Joint Committee on Taxation in connection with the July 11, 2007 Senate Finance Committee hearing (July 10, 2007, JCX-41-07) [jcx4107\_070710.pdf, 505K].
- *Testimony of Treasury Assistant Secretary for Tax Policy Eric Solomon before the Senate Finance Committee on the Taxation of Carried Interests* [SolomonSFC070711.pdf, 70K]. The Senate Finance Committee has posted the following material at its website:
  - [Links to the pening statements and testimony at its July 11, 2007 hearing.](#)
  - [A video recording of the July 11, 2007 hearing.](#)
  - [Links to the pening statements and testimony at its July 31, 2007 hearing.](#)
  - [A video recording of the July 31, 2007 hearing.](#)

- [Ways and Means Committee press release](#) on the carried interest legislation [WMpr070622.pdf, 58K].
- [Ways and Means Committee fact sheet](#) on the carried interest legislation [WMfact070622.pdf, 101K].
- [S. 1624](#), the Baucus-Grassley publicly traded partnership bill [s1624\_070614.pdf, 37K].
- The [Senate Finance Committee explanation](#) of S. 1624 [PTPexp070614.pdf, 28K].
- The [Senate Finance Committee press release](#) regarding the publicly traded partnership legislation [PTPpr070614.pdf, 43K].
- [H.R. 2785](#), the Welch publicly traded partnership bill [hr2785\_070620.pdf, 37K].

#### Important Notice to Readers

This material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matters.