Proposed Legislation Targets 'Carried Interests'

House Democrats last Friday (June 22) proposed legislation that would fundamentally change the way certain investment fund managers are taxed. In the words of its sponsors, the bill is designed to ensure that "the managers of investment partnerships who receive a carried interest as compensation will pay regular income tax rates rather than capital gains rates." Introduced by Rep. Sander Levin, the bill (H.R. 2834) is co-sponsored by the Chairmen of the House Committees on Ways and Means (Rangel) and Financial Services (Frank), and 10 other Democratic Ways and Means members.

The Levin bill comes on the heels of Senate and House proposals to tax as corporations publicly traded investment firms organized as partnerships, but if enacted it would have a much more sweeping effect. The Levin bill would cause profits interests in private equity funds, hedge funds, venture capital funds, real estate funds, commodities funds, and other investment partnerships to be taxed at ordinary income rates. Depending on the circumstances, the bill could also apply to profits interests in holding company partnerships and partnerships engaged in operating businesses.

Under current law, partners are generally taxed on a "pass-through" basis, so that the tax character of a partner's income (e.g., capital gain or ordinary income) is determined by reference to the character of the income of the partnership. The Levin bill would abandon this principle in the case of a partner who holds an "investment services partnership interest" (ISPI). Income allocated to the holder of an ISPI would generally be treated as ordinary income from the performance of services, regardless of the character of the partnership's income. For example, even if a partnership generated only capital gain income, the portion of that capital gain income allocated to the holder of an ISPI would be treated as ordinary income.

The bill defines an ISPI as any interest in a partnership that is held by a person who provides, "directly or indirectly," in the active conduct of a trade or business, a "substantial quantity" of advisory or management services with respect to "specified assets" of the partnership, including advice on buying, selling, valuing, or financing such assets, and including related support services. The terms "directly or indirectly" and "substantial quantity" are not defined. "Specified assets" are defined broadly to include equity and debt securities, real estate assets, and commodities, together with options and derivatives with respect to such assets.

Under the bill, if the holder of an ISPI contributes capital to the partnership, the portion of the partner's income that is "reasonably allocated" to the capital contribution would not be subject to the ordinary income rule and instead would be taxed under current law. The bill provides that the portion of income that is "reasonably allocated" to contributed capital may not exceed the amount of income any other partner not providing services would have received for the same amount of invested capital.

Anti-avoidance rules in the bill would tax gain on sale of an ISPI as ordinary income and treat a distribution in kind to the holder of an ISPI as a gain-recognition event for the partnership. Consistent with its basic approach, the bill would recharacterize any loss with respect to an ISPI as an ordinary loss, but the loss would be deductible only to the extent of ordinary income previously included with respect to the same ISPI.

Ordinary income created by the bill would count in determining a partner's self-employment tax liability and presumably would constitute unrelated business taxable income in the hands of a tax-exempt investor. An ISPI held by a foreign partner presumably would be subject to U.S. federal income tax to the extent the related services were performed in the U.S. The press release accompanying the bill notes that ordinary income created by the bill would not be "qualifying income" for purposes of the 90 percent "good income" safe harbor from the publicly traded partnership rules, so that the bill would constitute an alternative basis for taxing publicly traded investment advisory partnerships if the earlier proposed legislation fails. The bill would not apply, however, for purposes of the REIT "good income" qualification test.

The bill does not include transition rules or any effective-date guidance. Its prospects for passage are unclear, particularly in the Senate. The Ways and Means Committee has announced hearings on "tax fairness" in July.

Contact Information

If you have any questions about the bill, please contact a member of the Tax & Benefits Department.