



October 2009

RECENT PROPOSALS TO CHANGE THE TAXATION OF CARRIED INTEREST INCOME**CLIENT ALERT**

Congress and the administration are focused on changing the taxation of carried interest income from taxation as capital gains to that of ordinary income. In 2007, a bill introduced by Rep. Sander Levin (D-MI) that would require ordinary income taxation of carried interest income earned for investment management services passed the House, but was never enacted (H.R. 2834, 110th Cong., 1st Sess). The two most recent proposals to change the taxation of carried interest income are: Rep. Levin's legislation introduced in April 2009 ("House Proposal"), which is substantially similar to his 2007 bill; and the Obama administration's proposal described in the May 2009 Treasury Department explanation of revenue provisions contained in the president's budget ("Obama Proposal").

The central provisions in the House Proposal apply to persons that hold "investment services partnership interests," and would treat carried interest income earned for investment management services as income subject to tax at ordinary rates and possibly subject to self-employment tax. In addition, income from the sale of an investment services partnership interest would be treated as ordinary income. A limited exception would apply to income that is attributable to capital invested by the partner holding an investment services partnership interest, allowing for taxation of such income at capital gains rates. Notably, this exception would not apply in the case of an investment by any partner or the partnership of proceeds from a loan. There are additional rules applying to holders of investment services partnership interests, such as deferral of net losses allocated from a partnership and limitations on income received from certain "disqualified interests." Importantly, the House Proposal does not include a provision to grandfather any existing partnerships or carried interest arrangements.

The Obama Proposal takes an approach to taxation of carried interest that is similar to the House Proposal, with one significant difference: the administration would treat carried interest income paid to a partner for any type of service as ordinary income, without limiting the ordinary income treatment to income from investment services. Under this approach, all carried interests granted in exchange for any type of service provided to a partnership (referred to as "Services Partnership Interests" or "SPIs" in the proposal) would be subject to tax at ordinary income rates. While the Obama Proposal is vague, several Treasury officials have stated that it is appropriate to treat carried interest income attributable to services as compensation outside of the investment management context. Additionally, the Obama Proposal would provide rules similar to those in the House Proposal, such as the exception for carried interest income attributable to capital contributed by a partner. Because of the summary nature of the Green Book descriptions, it is difficult to ascertain the scope of these rules.

Circular 230 Notice: To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (a) avoiding penalties under the Internal Revenue Code, or (b) promoting, marketing, or recommending to another party any transaction or matter addressed herein.

This client alert provides only general information and should not be relied upon as legal advice. For more information, contact your Patton Boggs LLP attorney or one of the lawyers listed below.

Donald V. Moorehead
dmoorehead@pattonboggs.com
202-457-5212

Philip G. Feigen
pfeigen@pattonboggs.com
202-457-6142

Jonathan Babu
jbabu@pattonboggs.com
202-457-5342

www.pattonboggs.com

www.pattonboggs.com