

Robert R. Pluth Jr.

Practice Group Leader

312.258.5535

rpluth@schiffhardin.com**Robert E. Kolek**

312.258.5755

rkolek@schiffhardin.com**Colleen M. Feeney**

312.258.5717

cfeeney@schiffhardin.com**Robert J. Muething**

404.437.7052

rmuething@schiffhardin.com**Larry Jacobson**

312.258.5580

ljacobson@schiffhardin.com**Theresa M. H. Marx**

312.258.5562

tmarx@schiffhardin.com**Thomas R. Wechter**

312.258.5756

twechter@schiffhardin.com**Mike Zhiyuan Xu**

312.258.5836

mxu@schiffhardin.com**Eric A. French**

State and Local Tax

404.437.7022

efrench@schiffhardin.com

Taxing Carried Interests

The taxation of “carried interests” currently is a hot topic in tax circles. That interest has been fueled by a number of recent events, including the increasing importance of private equity funds and hedge funds in today’s financial markets, the Blackstone IPO, and increased attention by the press to the substantial amounts being paid to the owners of some carried interests.

This edition of *Tax Talk* focuses on the taxation of carried interests. We describe below the essential characteristics of carried interests, the current rules relating to the taxation of carried interests, and one current proposal being considered by Congress to change the taxation of carried interests.

What is a carried interest?

A carried interest generally is a right to receive a percentage of a partnership’s or fund’s profits without a corresponding obligation to contribute to the capital of the partnership or fund. A carried interest may be an interest in all partnership profits, or it may be an interest only in those profits earned after realization of a certain hurdle rate or payment of a certain preferred return. For example, the owner of a carried interest may be entitled to a percentage share of all partnership profits, such as 2%. Alternatively, an owner of a carried interest may not be entitled to any partnership profits until after the capital-contributing partners realize an internal rate of return on their contributions of a specified amount such as 15%, and thereafter the owner of the carried interest may be entitled to a significant share of all subsequent profits, such as 20%.

Hedge funds and private equity funds typically are structured as partnerships for federal income tax purposes. (Many such funds are organized as limited liability companies, and a limited liability company with more than one member is taxed as a partnership unless it elects to be treated as a corporation.) The managers of such funds typically are entitled to receive both management fees and a carried interest in the fund.

Current tax rules relating to carried interests

A person may acquire an interest in a partnership by (1) contributing capital to the partnership, (2) providing services to the partnership, or (3) providing some combination of capital and services. A person that contributes capital to a partnership generally is not taxed upon receipt of the partnership interest in exchange for the capital contribution. Similarly, a service partner generally is not taxed upon the receipt of a partnership interest in exchange for agreeing to provide services to the partnership. The IRS has taken the position that the general rule relating to a service partner's receipt of a partnership interest will not apply if (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income

from high-quality debt securities or a high-quality net lease, (2) within two years of receipt, the service partner disposes of the profits interest, or (3) the profits interest is a limited partnership interest in a publicly traded partnership. Also, a service partner generally will not be entitled to nonrecognition treatment on receipt of a profits interest if the service partner would be entitled to a share of liquidation proceeds from an immediate liquidation of the partnership. For example, if a partnership holds appreciated assets and a service partner is given a profits interest that includes a share of the asset appreciation that occurred before admission of the service partner, the profits interest will include a right to some of the proceeds from an immediate

liquidation of the partnership. In that event, the profits interest is treated as both a profits interest and a capital interest because the service partner immediately is entitled to a share of the partnership's assets or equity.

A partner holding a partnership interest includes in income his or her distributive share of partnership items of income and gain, including capital gain eligible for lower income tax rates. Thus, where a service partner receives a carried interest, the service partner will be required to include in income his or her allocable share of partnership income. The character of the partnership's income, ordinary or capital, will pass through to all of the partners of the partnership, including the service partners.

**A “carried interest”
generally is a right to
share in a fund's profits
without a corresponding
obligation to contribute
to the fund’s capital.**

Proposals to change the tax treatment of carried interests

Several members of the House of Representatives, including House Ways and Means Committee Chairman Charles Rangel, have introduced a bill that would change radically the tax treatment of carried interests. That bill would treat net income from an “investment services partnership interest” as ordinary income. An investment services partnership interest would be a partnership interest that is held by a person who provides a substantial amount of services to the partnership, such as advising the partnership in connection with its operations or capital transactions, managing the partnership or assets of the partnership, or arranging financing for the partnership’s activities. The bill would not apply to profits interests that are attributable to a partner’s invested capital.

Under the bill, a partner that contributes capital and provides services to the partnership would be required to make a reasonable allocation of partnership items between those that are attributable to invested capital and those that are attributable to services. An allocation would not be treated as reasonable if it would result in an allocation of 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.

The Senate Finance Committee held two hearings in July on the taxation of carried interests, and the House Ways and Means Committee held a hearing in September on the same issue. Senators Baucus and Grassley and House Ways and Means Chairman Rangel have indicated a continuing interest in examining the appropriate treatment of carried interests. It is impossible to predict at this point whether any of the current discussions will lead to any changes in the tax treatment of carried interests. We will continue to monitor legislative developments in this area along with any further guidance from the Treasury Department and the IRS relative to this income tax treatment of carried interests.

Please contact **Robert Muething** or **Robert Pluth** if you have any questions with respect to this article.

Our tax attorneys advise clients on the federal, state, local and foreign tax aspects of their business and investment activities. We counsel in the structuring of complex business transactions including mergers and acquisitions, reorganizations, other business combinations and restructurings, financing transactions (including leveraged leases and sale-leasebacks), joint ventures, and private equity and investment funds. We also assist in the implementation of affirmative tax planning opportunities such as the choice of business entity, the award of equity-based compensation for services rendered to businesses including LLCs, tax-deferred exchanges and maximizing the use of foreign tax credits. We also counsel businesses in connection with FIN 48 tax disclosure issues.

Our tax attorneys also handle all manner of federal, state and local tax controversies, at the audit and administrative appeals levels and in tax litigation, and advise in connection with disclosure and tax penalty mitigation. In conjunction with our white collar criminal defense attorneys, we also represent taxpayers in connection with actual or potential criminal tax investigations.

©2007 Schiff Hardin LLP.

This publication is for the general information of clients and friends of our firm. It does not provide legal advice for any specific matter. Readers should consult a lawyer directly for such advice. This publication, or parts of it, may be considered attorney advertising material under professional conduct rules applicable to lawyers.

