

# Client Alert

An informational newsletter from Goodwin Procter LLP

## Developments in Carried Interest Taxation

As previously described in our [March 3, 2009 Client Alert](#), President Obama's fiscal year 2010 budget proposal includes a provision regarding the taxation of "carried interests" as ordinary income. The Treasury Department's General Explanation of the Administration's Fiscal Year 2010 Revenue Proposal (the "General Explanation"), released earlier this month, provides some additional detail regarding the President's proposal. In addition, Representative Sander Levin (D-MI) recently introduced carried interest legislation (the "Levin Bill") that generally tracks prior legislative proposals. Because of the potential broad scope of the President's proposal and the Levin Bill, this alert describes several of their significant features.

### Expansion of Affected Partnership Interests

The most notable feature of the General Explanation is the expansion of the category of affected partnership interests. Prior legislative proposals would affect only interests in investment services partnerships. However, the President's proposal would tax as ordinary income (subject to self-employment tax) a partner's share of income from a "services partnership interest" ("SPI"). Any gain on sale of an SPI would also be taxed as ordinary income.

While the General Explanation does not provide any details as to how the Administration will define an SPI, the proposal appears to apply to all partnership carried interests received for services, regardless of the type of business involved. In that case, the universe of partnership interests subject to ordinary income taxation would include:

- investment fund carried interests
- a general partner's interest in partnership profits attributable to a management fee waiver (a "cashless contribution" or "management fee conversion" structure)
- profits interests granted to management in an operating partnership
- profits interests in a holding partnership granted to employees of the partnership's corporate subsidiaries
- any other partnership interest held by a service provider if the service provider receives a greater share of partnership income than is attributable to its proportionate share of invested capital

### **Invested Capital Exception**

The General Explanation is similar to the Levin Bill in providing an exception from ordinary income treatment for the portion of an interest that is attributable to a partner's invested capital. While the General Explanation does not describe the exception in detail, prior legislative exceptions have been narrow and, if enacted as proposed, would have failed to protect many types of capital interests held by service partners.

### **Property Distributions**

The General Explanation does not mention a significant feature of the Levin Bill that would tax an affected partner on the amount of gain inherent in property distributed by the partnership to the partner at the time of distribution. Any elimination of the current rule that allows deferral of current income recognition by way of a tax-free partnership distribution would adversely affect many common transactions, such as a partnership distribution of portfolio company securities to a general partner (a "carry-in-kind" transaction). The General Explanation's failure to mention this feature should not be interpreted to mean that it will not appear in the draft statutory language.

### **Non-U.S. Partners**

While early legislative proposals appeared to tax non-U.S. owners of affected interests as though they recognized services income, which presumably would be taxable in the United States, more recent proposals appear not to convert the character of the underlying income of non-U.S. partners to taxable services income. However, non-U.S. owners of profits interests should continue to monitor developments in this area as the legislative process progresses.

### **Effective Date**

The President's proposal would tax profits interests as ordinary income beginning in 2011. The General Explanation provides no indication of a grandfather or transition rule for existing profits interests.

### **Conclusion**

If the President's proposal becomes law, every partnership profits interest structure will be affected and will need to be re-evaluated. Additional developments in this area are likely, and we will continue to keep you informed of those developments.

If you have any questions about the issues addressed in this Client Alert, please contact your usual Goodwin Procter attorney, or any of the attorneys listed below.

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