

## **Viewpoint: Private Sector Abuzz Over Possible Changes to Tax Treatment of Carried Interests**

On March 2, one lobbyist working in the hedge fund area reported that the Senate Finance Committee staff was working on a proposal that would impose ordinary income tax treatment on income from a carried interest or profits interest rather than allowing the character of the income to be determined at the partnership level. As this report circulated by e-mail in Washington, it took on new content. Part of that new content focused on treating profits interests received in fee waiver transactions associated with a leveraged buyout and hedge fund transaction as ordinary income at the time of waiver.

On March 7, two law firms reported a similar rumor, adding to it the possibility that the House Ways and Means Committee was also looking at a proposal. One of these reports also said that the committees were considering increasing top individual and capital gains rates.

Interest in carried interest transactions appears to be centered in the Finance Committee Republican staff. Both Finance Committee Chairman Max Baucus, D-Mont., and Ways and Means Committee Chairman Charles Rangel, D-N.Y., have reportedly said they are not working on a carried interest proposal. Press reports tie the carried interest issue to Grassley's interest in hedge funds, but state only that carried interests are part of a larger review.

### **What Could Happen**

The private-sector buzz about this topic may have made introduction of a proposal inevitable. At this point, the rumor has been repeated broadly and modified in the retelling to such an extent that congressional staff is being asked questions about how they plan to limit carried interest arrangements. These questions, in and of themselves, may be a sufficient impetus for the House and Senate taxwriting committees to take some action.

**Taxwriters' Rationale for Acting** – If taxwriting committee staff decides to attack carried interest arrangements, it likely will characterize them as abusive transactions. They will argue that services income that should be taxed at ordinary rates is inappropriately being converted to capital gain income.

**Possible Scope of a Proposal** – The scope of this unseen proposal, obviously, is unclear. Unanswered questions would include:

- Whether tax would be imposed at the time the carried interest is received or when profits arise and are distributable;
- Whether the proposal targets all carried interests or only those associated with fee waivers; and
- Whether the proposal would focus only on hedge funds and provide exceptions for certain industries such as private equity or real estate, or specific activities such as venture capital investments.

**Form** – A carried interest-related revenue raising provision is unlikely to move as a separate bill, but could be tied to a larger measure such as alternative minimum tax reform or an extension of expiring provisions for which revenue offsets are required under the newly readopted pay-as-you-go budget rules.

**Effective Date Issues** – Another unknown issue is what effective dates would be contained in a proposal if one emerges. There are several options. Congress could apply the rules to: (1) new funds created after a specific date, (2) income from fund investments made after a specific date, or (3) income received after a specific date from either new or existing transactions.

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