

Authored by David B. Strong

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## CHANGES ON THE HORIZON – TAXATION OF CARRIED INTERESTS

Now that health care legislation has been passed, Congress is focusing on tax legislation. One of the topics Congress is focusing on is the tax treatment of carried interests. Congress is proposing significant changes to the tax treatment of carried interests, including the recharacterization of capital gains as ordinary income. Carried interests legislation could be adopted by Memorial Day as part of a bill that would extend a number of expiring tax provisions. We are monitoring this situation closely and will publish additional Client Alerts as more information becomes known.

Carried interests are a popular tool for issuing equity compensation to persons who provide services to limited liability companies and other business entities treated as partnerships for tax purposes. A carried interest is a form of equity that entitles the holder to receive allocations and distributions that are disproportionately greater than the holder's invested capital. One advantage of a carried interest is that the holder may receive long-term capital gains treatment on sale of the entity's assets or sale of the carried interest.

The tax treatment of carried interests began to receive attention from Congress back in 2007. Since that time, the House of Representatives has considered different bills that would alter how carried interests are taxed. Based upon draft legislation, Congress is proposing to change the tax treatment of carried interests in the following ways:

- Recharacterizing capital gains as ordinary income.
- Limiting utilization of losses.
- Imposing self-employment tax.

Carried interests were a topic of significant discussion during the American Bar Association Section of Taxation's (ABA) meetings in Washington, D.C. in early May. Now that health care legislation has been passed, Congress is focused on tax legislation. As the ABA's meetings wound up on May 8<sup>th</sup>, there was a strong sense that carried interests legislation could be adopted by Memorial Day as part of a bill that would extend a number of expiring tax provisions.

There have been a number of headlines over the last few weeks about developments related to carried interests legislation. The ABA submitted comments to the House Ways & Means and Senate Finance Committees on May 11<sup>th</sup>. On May 19<sup>th</sup>, the House indicated that it was considering a floor vote on the extenders bill by the end of the week, although on May 20<sup>th</sup> House Speaker Nancy Pelosi said that consideration of the legislation would slip until the week of May 24<sup>th</sup>. Also, in light of the fact that the Senate has never passed carried interests legislation, there is the possibility that debate in the Senate could delay passage of any legislation adopted by the House. Congress is currently scheduled to leave on May 28<sup>th</sup> and return after June 7<sup>th</sup> for the Memorial Day recess.

Uncertainty exists about the nature of any legislation. Although speculation exists about whether legislation would include any industry carve-outs, House Ways & Means Committee Chair Sander Levin has made comments indicating that any carve-outs are unlikely. In addition, draft legislation as of May 20<sup>th</sup> indicated that, in the case of individuals, the recognition of ordinary income in respect of a carried interest would be phased in from the date of enactment through January 1, 2013.

We continue to monitor this situation closely and will publish additional Client Alerts as more information becomes known. In the meantime, please contact one of the listed attorneys with any questions.

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### HRO CONTACTS Federal Income Tax

**David B. Strong**  
Partner  
david.strong@hro.com  
303-866-0263

**Charles B. Bruce Jr.**  
Partner  
charles.bruce@hro.com  
303-866-0600

**Charles A. Ramunno**  
Partner  
charles.ramunno@hro.com  
303-866-0232

**Paul E. Smith**  
Partner  
paul.smith@hro.com  
303-417-8508

**Thomas E. Yearout**  
Partner  
tom.yearout@hro.com  
303-866-0297

[www.hro.com](http://www.hro.com)



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