

# Client Alert

An informational newsletter from Goodwin Procter LLP

## President Obama Proposes to Tax “Carried Interests” as Ordinary Income

President Obama’s fiscal year 2010 budget proposal, which was submitted to Congress on February 26, 2009, calls for legislation to tax “carried interests” as ordinary income beginning in 2011. Although the proposal offers few specifics, if enacted in any form, the legislation could affect virtually all venture capital, private equity, hedge, real estate and other similar private investment funds.

### Background

Most private investment funds organized by U.S.-based sponsors are structured to allocate to the sponsor entity a “carried interest” (sometimes referred to as a “promote” or an “incentive allocation”). For non-tax purposes, a carried interest often is desirable because, unlike a fixed fee, it aligns the interests of sponsors and investors with the success of the fund.

Under current law, the grant of a carried interest generally is not taxable for U.S. federal income tax purposes. Instead, the sponsor generally recognizes income and gain (like any other partner) as and when allocations of partnership income and gain are made with respect to the carried interest. In the case of partnerships that generate long-term capital gains, the sponsor may be taxable on its carried interest share of such gains at preferential long-term capital gains rates (currently a maximum federal rate of 15%).

### President’s Proposal

The President’s budget proposal contains a single line item that calls for taxing a carried interest as ordinary income beginning in 2011, but provides no further details. As such, the scope of the proposal is unclear. Resulting legislation could tax the grant of a carried interest, treat allocations in respect of a carried interest as ordinary income rather than long-term capital gains or take some other form. Given the absence of specifics, it is perhaps premature to seek alternative structures that can be adopted on a pre-emptive basis, but sponsors entering into new fund agreements should at least consider the possibility that those agreements may need to be revised when, and if, definitive details emerge.

Proposals to change the taxation of carried interests are not new. Certain members of Congress have advocated such changes over the last several years. For example, in 2008, the U.S. House of Representatives passed a bill that would have converted any capital gains recognized in respect of a carried interest (including upon a disposition) into ordinary income for the performance of services, which also would

have been subject to self-employment taxes. That bill would have applied to carried interests in new as well as existing investment funds. It also included provisions (and penalties) designed to prevent taxpayers from using alternative structures to circumvent the bill's purposes.

Although the 2008 bill contained significant technical flaws and ultimately failed to pass in the U.S. Senate, its framework could provide a starting point for new legislation drafted to implement the President's budget proposal. Any new legislation could, of course, also differ from the bill, perhaps significantly.

### Conclusion

Given the preliminary nature of the budget proposal, it is premature to implement changes with respect to existing fund structures. We will continue to monitor any developments in this area and issue additional client alerts as necessary.

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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