

March 6, 2007

Congress Considers Tax Law Changes Affecting Investment Funds

Capital Gain for Carried Interest and Deferred Compensation At Risk?

Various members of the congressional tax-writing committees (the Senate Finance Committee and the House Ways and Means Committee) are considering tax issues that directly affect the treatment of investment funds and their managers. This activity is likely the result of increased attention being given to regulatory and other matters affecting “hedge funds”.

In a prior memo, we described the severe limitations that would be placed on deferred compensation (including deferred management and incentive fees) under legislation that was approved by the Senate Finance Committee. (See our January 24 memo at <http://www.paulweiss.com/resources/pubs/Detail.aspx?publication=1311>.) That legislation was passed by the Senate as part of minimum wage legislation, but the House version of the minimum wage legislation did not include the deferred compensation limits, and the House-Senate conference process has not yet begun.

More significantly, other proposals are actively being considered and developed, particularly by Republican members of the Senate Finance Committee. The reaction to and discussion of the minimum wage legislation has led to a more intense examination of what the legislators refer to as “hedge fund taxation,” which appears to encompass various tax rules that govern the tax treatment of investment funds. There is no doubt that the committee is looking carefully at deferred compensation structures that are frequently utilized in offshore funds. Significant consideration is also being given to carried interest issues, with the focus being whether to characterize that income as compensation for services and not as long-term capital gains. It is likely that other practices, such as fee waivers, will be closely examined. Although tax issues affecting funds are attracting most of the attention now, it is possible that other partnership tax issues (e.g., profits interests in private equity transactions) will also be considered.

We also expect other proposals to emerge in the future, most of which will focus on whether various types of income are properly characterized as ordinary income or as capital gain.

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