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Highlights of Rangel's 2007 Tax Reform Bill

On October 25, 2007, House Ways and Means Committee Chairman Charles Rangel unfurled his 129 page tax reform bill (H.R. 3970, the Tax Reduction and Reform Act of 2007), which generally would raise individual tax rates, lower corporate tax rates and repeal the existing alternative minimum tax. The revenue to offset these changes is obtained mostly from a surtax on high-income individuals, but the bill also imposes tax increases on managers of investment funds. The bill includes the following noteworthy provisions:

- Taxation of Carried Interest as Ordinary Income. The bill would require investment fund managers to treat carried interest as ordinary income received in exchange for the performance of services to the extent that such carried interest does not reflect a reasonable return on invested capital. To the extent that such carried interest does reflect a reasonable return (relative to partners not providing any services) on invested capital, such interest would continue to be treated as capital gains. An investment fund manager's invested capital would not be credited with the proceeds of any loan or other advance made or guaranteed (directly or indirectly) by any other partner or the partnership, and a loan by any other partner would be treated as invested capital by that partner. (These provisions are intended to prevent the creation of carried interests by an arrangement in which partners contribute capital in the form of debt.) The bill does not contain a proposed effective date for this provision (i.e., the proposed date is left blank in the bill).

- Current Inclusion of Deferred Compensation Paid by Offshore Hedge Funds. The bill would prevent investment fund managers from deferring fees from offshore hedge funds (and certain other entities described below). The summary notes that under current law, executives and other employees are generally permitted to defer recognition of income from compensation until such compensation is actually paid, so long as the corporate employer also defers taking the related deduction. The bill would require fund managers to accrue (and recognize currently) fee income that is payable by an offshore hedge fund or by a partnership that has mainly tax-exempt entities and foreign persons not subject to foreign income tax as investors (in which cases there would be no offsetting

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deduction to be deferred). This provision is proposed to be effective for taxable years beginning after December 31, 2007. The bill also requires recognition of all amounts deferred as of December 31, 2007 over a 4-year period (2008 through 2011).

- Modification of Debt-Financed UBTI Rules for Certain Investment Partnerships. The bill would allow tax-exempt entities to invest directly in certain investment partnerships without recognizing unrelated business taxable income. This provision would generally eliminate the current incentive for tax-exempt entities to structure their fund investments through use of offshore "blocker" corporations in cases where the risk of UBTI arises solely because of debt financing in the investment partnership. This provision would be effective only after the date of enactment.

- Shareholder-Employees of Service S Corporations and Partner-Employees of Service Partnerships Liable for Self-Employment Taxes. The bill would subject shareholder-employees of S corporations that are engaged in the services business to self-employment tax in respect of the portion of their distributive share attributable to such services business. The bill would make conforming changes to the treatment of limited partner-employees of partnerships that are engaged in the services business. This provision would be effective for taxable years beginning after December 31, 2007.

- Surtax on Individuals Earning More Than a Threshold Amount. The bill would impose a surtax of (i) 4% on the amount of an individual's annual adjusted gross income (reduced by investment interest but no other deductions) that exceeded a threshold amount to be determined by the Treasury (but which would not be less than $150,000, or $200,000 for married couples filing joint returns) plus (ii) an extra 0.6% on the amount of an individual's annual adjusted gross income that exceeded $250,000 ($500,000 for married couples filing joint returns). This provision would be effective for taxable years beginning after December 31, 2007.

- Amortization of Section 197 Intangibles. The bill would increase the amortization period for Section 197 intangibles from 15 years to 20 years. This provision would apply to property acquired after the date of enactment.

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