



## The Final Nail for Carried Interest?

Authored by Adrienne M. Baker and  
Joshua Milgrim

February 2025



## The Final Nail for Carried Interest?

February 2025 / Adrienne M. Baker and Joshua Milgrim

Representative Marie Gluesenkamp Perez (WA-03) and Representative Don Beyer (VA-08) on February 6, 2025, introduced legislation entitled the “Carried Interest Fairness Act of 2025” (the “House Bill”). The House Bill is designed to tax income from carried interests at the same ordinary income rates applicable to wages. On the same date, Senator Tammy Baldwin (WI) introduced a companion bill (with identical text) in the U.S. Senate (the “Senate Bill”). The carried interest provisions included in the House and Senate Bills (collectively referred to as the “Bill”) are summarized below.

### Executive Summary

The Bill would alter the taxation of carried interest in a more sweeping fashion than previously enacted legislation by essentially requiring that all income derived from a carried interest be taxable at ordinary income rates. Such income would also be subject to self-employment taxes. Similar to current law, an exception would apply to certain interests in partnership capital. Absent a contrary election, recipients of carried interest that are subject to vesting provisions would include the liquidation value of the interest (reduced by any amount paid for the interest) in income at the time of grant. The Bill would extend this carried interest treatment beyond investment partnership interests to include certain equity (and equity-like) interests in certain non-U.S. corporations, special purpose acquisition companies and S corporations.

### Background and Current Law

Alternative fund managers commonly receive a performance-based return, in addition to a management fee, for services provided to a managed fund. For funds that are treated as partnerships for U.S. federal income tax purposes, the performance-based return generally is structured as a “performance allocation” (in respect of hedge funds and other funds investing primarily in marketable securities) or a “carried interest” (in respect of private equity funds and other funds investing primarily in illiquid assets). In either case, this performance-based return is intended to be treated as a profits interest in the partnership. For convenience, the remainder of this summary refers to both performance allocations and carried interests as “carried interests.”

Section 1061 of the Internal Revenue Code of 1986, as amended (the “Code”), addresses the taxation of carried interest. Because carried interest is subject to the same risk of loss as a partnership interest received by a third-party investor in exchange for a capital contribution, the net profits allocated to a fund manager in respect of its carried interest are treated as a distributive share of partnership profits. Accordingly, except as otherwise provided by Section 1061,<sup>1</sup> the character of the profits earned by the partnership generally flows through to the fund manager in the same manner as for other holders of partnership interests. Section 1061, which was added to the Code as part of the Tax Cuts and Job Act of 2017, extends the general long-term capital gain holding period from more than one (>1) year to more than three (>3) years in the case of gains derived from carried interests. Section 1061 does not alter the taxation of income that is taxable at long-term capital gain rates irrespective of holding period (for example, qualified

---

<sup>1</sup> All Section references herein refer to sections of the Code.

dividends, certain mark-to-market gains from Section 1256 contracts, and Section 1231 gains (relating to certain depreciable and real property used in a trade or business).

*Observations: A common misperception is that hedge fund managers enjoy long-term capital gain treatment on all carried interest profits. In fact, a classic hedge fund strategy is likely to generate primarily short-term capital gains and losses due to frequent trading to capture short-term market swings. In the absence of long-term capital gain, the manager would not receive the benefit of reduced long-term capital gain tax rates.*

## Proposed Changes

### *General Treatment of Carried Interest Income as Ordinary Income*

The Bill would replace Section 1061 of the Code with a new Section 710. In respect of a carried interest (defined in the Bill as an “investment services partnership interest”), any net capital gain (that is, the excess of net long-term capital gain over net short-term capital loss) derived with respect to such interest for any partnership year would be treated as ordinary income. Net capital loss (that is, the excess of capital loss over capital gain) with respect to such interest for any partnership taxable year would be treated as ordinary loss to the extent that the aggregate net capital gain treated as ordinary loss for all prior taxable years of the partnership exceeds the aggregate net capital loss treated as ordinary loss for all prior taxable years of the partnership.

In addition, the following rules would apply in respect of amounts allocable to an investment services partnership interest:

- (i) Section 1231 gains and losses (relating to certain depreciable and real property used in a trade or business) would be treated as long-term capital gains and losses for purposes of determining net capital gain that would be subject to ordinary income treatment under Section 710 of the Code;
- (ii) Dividends would not be eligible for treatment as qualified dividends (which otherwise are taxable at reduced long-term capital gain rates); and
- (iii) The exclusion for gain from the sale or exchange of certain “qualified small business stock” under Section 1202 of the Code would not apply to otherwise qualifying gain.

*Observations: The proposed amendments would apply ordinary income rates to additional categories of carried interest income that currently are taxable at long-term capital gain rates irrespective of holding period (for example, qualified dividends, Section 1231 gains and presumably (though not explicitly referenced) Section 1256 contracts).*

### *Scope of Application*

The changes proposed by the Bill generally would apply to an “investment services partnership interest,” which refers to an interest in an investment partnership acquired or held by any person in connection with the conduct by such person (or any person related to such person) of a trade or business described in the Bill. A trade or business is described in Bill if such trade or business primarily involves the performance of any of the following services with respect to assets held (directly or indirectly) by one or more investment partnerships:

- (i) Advising as to the advisability of investing in, purchasing or selling any specified asset;

- (ii) Managing, acquiring or disposing of any specified asset;
- (iii) Arranging financing with respect to acquiring specified assets; and
- (iv) Any activity in support of any service described in items (i) through (iii) above.

Specified assets generally include securities, real estate held for rental or investment, interests in partnerships, commodities, cash or cash equivalents, or options or derivative contracts with respect to any of the foregoing.

*Observations: The inclusion of “interests in partnerships” within the definition of “specified assets” noticeably departs from current law; Section 1061 includes a partnership interest as a specified asset only to the extent of the partnership’s proportionate interest in any of the other assets included within such definition.*

The term “investment partnership” means any partnership if, at the end of any two consecutive calendar quarters ending after the date of enactment of the Bill, (i) substantially all of the assets of the partnership are specified assets (determined without regard to certain intangible assets (including goodwill, going concern value, and certain intellectual property rights), and (ii) less than 75 percent of the capital of the partnership is attributable to qualified capital interests that constitute property held in connection with a trade or business of the owner of such interest. For this purpose, a look-through rule applies to a wholly owned partnership or non-U.S. corporation that is engaged in the same trade or business and, in the case of a non-U.S. corporation, does not engage in a trade or business in the United States.

For purposes of determining whether a partnership interest is held in connection with a trade or business, the owner of the interest would be treated as engaged in the trade or business of certain related persons, and such interest would be treated as held by such owner in connection with a trade or business during any taxable year if such interest was so held by such person during any preceding three-taxable-year period.

### *Capital Interest Exception*

Similar to current law, the Bill would provide an exception for certain capital interests, which the Bill refers to as “qualified capital interests.” For this purpose, a “qualified capital interest” is an interest in partnership capital that is attributable to (i) the fair market value of any money or other property contributed to the partnership in exchange for such interest, (ii) any amounts that have been included in gross income under Section 83 with respect to the transfer of such interest, and (iii) the excess (if any) of (A) any items of partnership income and gain taken into account under Section 702 with respect to such interest, over (B) any items of partnership deduction and loss so taken into account. Excluded from such definition is any interest to the extent acquired in connection with the proceeds of any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or any person related to any such other partner or the partnership). This exclusion would not apply to the extent the loan or other advance was repaid before the date of enactment of Bill unless such repayment was made with the proceeds of a loan or other advance described in the preceding sentence.

Items of gain and loss (and any dividends) that are allocated to a qualified capital interest would not be subject to ordinary income treatment under Section 710 if (i) allocations of partnership items are made to such qualified capital interest in the same manner as such allocations are made to other qualified capital interests held by partners who do not provide any of the services specified in Section 710 and are not related to the holder of the qualified capital interest, and (ii) the allocations made to such other interests are significant compared to the allocations made to such qualified capital interest. Allocations would not be treated as failing to meet this requirement merely because such

allocations (i) represent a lower return than the allocations made to other qualified capital interests, or (ii) do not reflect the cost of services which are provided (directly or indirectly) to the partnership by the holder of such interest (or a related person). In the case of tiered partnerships, all items which are allocated in a manner that meets the requirements described above to qualified capital interests in a lower-tier partnership would retain such character to the extent allocated on the basis of qualified capital interests in any upper-tier partnership.

*Observations: Similar to current law, the Bill contains an exclusion for capital interests, and reflects market practice in not requiring a carried interest recipient to bear management fees and similar charges in respect of such capital interest. As drafted, the Bill would allow recognized income and gain in respect of a carried interest that is retained in a partnership to be treated as a qualified capital interest in a subsequent taxable year if allocations made with respect to such retained income and gain satisfy the conditions otherwise applicable to qualified capital interests as described above. This can be of particular benefit to hedge fund managers that prefer to participate in future performance by retaining their performance allocations in their funds. Performance allocations are credited to the recipient's capital account and, if not distributed, generally are allocated a pro rata share of partnership profits and losses in subsequent partnership taxable years.*

### *Extension of Application to Other Managed Entities*

The Bill contains rules that would extend the application of Section 710 to certain equity (and equity-like) interests in investment entities other than partnerships, including non-U.S. corporations (substantially all of the income of which is not effectively connected with the conduct of a trade or business in the United States or subject to a comprehensive foreign income tax), special purpose acquisition companies ("SPACs") and (to the extent provided in future regulations) S corporations. An affected interest would be treated in the same manner as an investment services partnership interest if held (directly or indirectly) by a person who performs (directly or indirectly) investment management services for the investment entity, and the value of such interest (or payments thereunder) is substantially related to the amount of income or gain (whether or not realized) from the assets with respect to which the investment management services are performed.

*Observation: The parameters of this portion of the Bill (including its application to S corporations) are left largely to the U.S. Department of the Treasury to define through future regulations. What seems clear is that no exception is intended for interests in "passive foreign investment companies" ("PFICs"), including those that are subject to a PFIC "qualified electing fund" ("QEF") election.*

### *Additional Changes*

If enacted in its current form, the Bill would effect other changes to the treatment of carried interest, including with respect to dispositions of investment services partnership interests, dispositions of partnership property with respect to investment services partnership interests and transfers of any partnership interest in connection with the performance of services. These changes are summarized separately below.

### *Dispositions of Carried Interests*

With respect to dispositions of investment services partnership interests, any resulting gain would be treated as ordinary income; any resulting loss would be treated as ordinary loss, subject to similar aggregate ordinary income limitations described above in respect of ordinary loss treatment. In addition, current gain recognition would apply to any such transfer other than by gift or inheritance. In the case of a contribution of an investment services partnership interest to a partnership in exchange for an interest in such partnership, a taxpayer may, however, elect to avoid

current recognition treatment by agreeing to treat the partnership interest received in the exchange as an investment services partnership agreement and complying with related reporting and recordkeeping requirements. In the case of a disposition by death or inheritance, the interest would retain its treatment as an investment services partnership interest in the hands of the recipient. Furthermore, in the case of a transfer at death, any amount that would have been treated as ordinary income under Section 710 had the decedent sold the interest immediately before his or her death would be treated as income in respect of a decedent under Section 691 of the Code.

### *Distributions with Respect to Carried Interests*

In the case of any distribution of partnership property to a partner in respect of an investment services partnership interest, the recipient partner would recognize gain equal to the excess (if any) of the fair market value of the distributed property over the partner's adjusted basis in such property (as determined without regard to Section 710). Any such gain would be treated as ordinary income to the same extent and in the same manner as an equivalent increase in such partner's distributive share of partnership taxable income if, immediately prior to the distribution, the partnership had sold the distributed property at fair market value and all of the gain from such disposition were allocated to such partner. The basis of the distributed property in the hands of the recipient partner would be the fair market value of such property. In the case of a distribution of a partnership interest in connection with an otherwise tax-free contribution (or deemed contribution) of any property of the partnership pursuant to a transaction described in Section 708(b)(2) of the Code (relating to partnership mergers and divisions), a taxpayer may, however, elect to avoid current recognition treatment by agreeing to treat the partnership interest received in the exchange as an investment services partnership agreement. Certain reporting and recordkeeping requirements (similar to those referenced above with respect to dispositions of investment services partnership interests) would also apply.

### *Modification of Section 83(b) Election with Respect to Transfers of Partnership Interests*

The Bill would modify Section 83 of the Code to include a special rule in respect of transfers of partnership interests. In the case of a partnership interest that is transferred in connection with the performance of services, the fair market value of the interest would be deemed to equal the amount of the distribution that the recipient partner would receive in respect of such interest if, at the time of such transfer, the partnership disposed of its assets at fair market value and liquidated. The recipient partner would be deemed to have made an election (under Section 83(b)(1) of the Code) to include in gross income the fair market value of the interest so determined, reduced by the amount (if any) paid for the interest. A recipient partner could, however, affirmatively elect not to have such deemed election treatment apply. This opt-out election would be made under rules similar to those currently applicable to Section 83(b) elections.

*Observations: This proposed amendment effectively would change the default treatment of all partnership interests received in connection with the performance of services. A recipient partner would be deemed to have made a Section 83(b) election, unless the partner affirmatively elected to not include the fair market value of the interest (less any amount paid for the interest) in income at the time of receipt. Presumably, such opt-out election would be subject to the same 30-day deadline currently applicable to Section 83(b) elections.*

### *Impact on Other Provisions of the Code*

Beyond ensuring ordinary income treatment for income derived from carried interests, the Bill would amend other provisions of the Code in ways that adversely impact carried interest holders. Included among these proposed changes are the following amendments:

- (i) Subject to certain exceptions (including for certain partnerships held by real estate investment trusts (“REITs”)), income from investment services partnership interests would not constitute “qualifying income” for purposes of applying the qualifying income exception to taxation of a publicly traded partnership as a corporation;
- (ii) Investment services partnership interests that are held by a partnership would be treated as “hot assets” giving rise to ordinary income in the case of certain sales or exchanges (or distributions treated as sales or exchanges) of interests in such partnership;
- (iii) Increased penalties would apply to certain underpayments of tax attributable to non-compliance with Section 710;
- (iv) Self-employment taxes would apply to income from investment services partnership interests and similarly treated interests in other investment entities (described above); and
- (v) Amounts treated as ordinary income or loss under Section 710 would be separately reported to and taken into account by affected partners for purposes of determining their U.S. federal income tax liability.

## Effective Date

The amendments made by the Bill generally would apply to taxable years ending after the date of enactment. For a partnership taxable year that includes the date of enactment, the amendments would apply to the lesser of (i) the net capital gain for the entire partnership taxable year and (ii) the net capital gain determined by taking into account only items attributable to the portion of the partnership taxable year following such date. The amendments applicable to (i) Section 83 of the Code (relating to transfers of partnership interests in connection with the performance of services) and (ii) dispositions and distributions of partnership interests would apply to transfers, dispositions and distributions occurring after the date of enactment. The amendments applicable to affected interests in investment entities other than partnerships would take effect on the date of enactment.

*Final Observations: It is difficult to predict the timing and content of any future legislative developments affecting the taxation of carried interest. The search for revenue offsets to preserve expiring tax cuts may bolster bipartisan support for some form of legislation this year. The amendments contained in the Bill, if enacted, would extend ordinary income treatment to essentially all income derived from carried interests and subject such income to self-employment taxes. While this may call into question any remaining benefit to be derived from carried interest arrangements, the Bill appears to impact only carried interest recipients. Individual investors may still benefit from structuring a manager's performance-based returns as a carried interest. Carried interests do not present the same risk to such investors of limited or no deductibility of investment expenses that may apply to performance-based fees. Carried interest arrangements may also mitigate potential adverse consequences to carried interest recipients that may arise in connection with deferred compensation arrangements.*

This update was authored by:



**Adrienne M. Baker**  
Partner  
Boston  
+1 617 728 7151  
[adrienne.baker@dechert.com](mailto:adrienne.baker@dechert.com)



**Joshua Milgrim**  
Partner  
New York  
+1 212 641 5659  
[joshua.milgrim@dechert.com](mailto:joshua.milgrim@dechert.com)

© 2025 Dechert LLP. All rights reserved. This publication should not be considered as legal opinions on specific facts or as a substitute for legal counsel. It is provided by Dechert LLP as a general informational service and may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome. We can be reached at the following postal addresses: in the U.S.: 1095 Avenue of the Americas, New York, NY 10036-6797 (+1 212 698 3500); in Hong Kong: 31/F Jardine House, One Connaught Place, Central, Hong Kong (+852 3518 4700); and in the UK: 160 Queen Victoria Street, London EC4V 4QQ (+44 20 7184 7000). Dechert internationally is a combination of separate limited liability partnerships and other entities registered in different jurisdictions. Dechert has more than 900 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Hong Kong, Ireland, Luxembourg, Singapore, the United Arab Emirates, the UK and the U.S. Further details of these partnerships and entities can be found at [dechert.com](http://dechert.com) on our [Legal Notices](#) page.