

May 14, 2004

Investment Funds Update – Proposed Tax Legislation

On May 11, the Senate approved the Jumpstart Our Business Strength (JOBS) Act, which includes one provision that, if it becomes law, could have a significant impact on certain private investment funds, and other entities structured as partnerships for U.S. income tax purposes. Under current law, if a partnership makes an election under section 754 of the Internal Revenue Code, then the partnership is required to make adjustments to the tax basis of its assets upon a transfer of an interest in the partnership, and on the occurrence of certain other events. Many investment funds have chosen not to make this election, even if it might be advantageous in a particular case, because the election is irrevocable and these funds prefer to avoid the accounting burdens involved in making the required basis adjustments.

The JOBS Act makes these basis adjustments mandatory, rather than elective. With the mandatory adjustment, for example, a sale of an interest in a fund of funds would require tax basis adjustments in the assets of each of the funds in which the fund of funds owned an interest. This legislation will now be considered in the House, and there will be considerable political pressure for the House to enact a similar bill, because the JOBS Act repeals the extraterritorial income (ETI) provisions of the Code, which have been held illegal by the World Trade Organization, which is currently imposing tariffs to induce the United States to repeal ETI.

The mandatory basis adjustment provision appears likely to be included in the House legislation, if a bill is enacted this year, and therefore it also appears likely to be in the final legislation. We understand, however, that various investment funds and several industry associations have begun efforts to limit the mandatory basis adjustment rules so that it would not have an impact on most investment funds.

If you have any questions concerning this proposal, please contact a partner in our Tax Department.

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