E-ALERT | Tax

June 1, 2010

CARRIED INTERESTS

On May 28, 2010, the House of Representatives passed the "American Jobs and Closing Tax Loopholes Act" (the "Act"). The Act would add a new section to the Internal Revenue Code (Section 710) which is a modified version of legislation passed by the House in late 2009 that would have treated allocations of gain on carried interests held by investment fund sponsors as ordinary income. Unlike the prior legislation passed by the House but that failed to win Senate approval, the Act is the product of negotiations between the House Ways and Means Committee and the Senate Finance Committee which theoretically increases the likelihood of its successful enactment. The Senate will not, however, take action on the Act until at least the week of June 7th and it is uncertain at this time whether the Act will pass.

The carried interest provision contained in the Act applies to tax years ending on or after January 1, 2011. Unlike the version of the legislation released by the Chairmen of the House Ways and Means Committee and the Senate Finance Committee, Section 710 does not apply to allocations with respect to carried interests in 2010.

The Act's carried interest provision is substantially similar to the legislation passed by the House in 2009 with one important exception. For the 2011 and 2012 tax years, 50% of carried interest allocations will be taxed as ordinary income with the remaining 50% eligible for long-term capital gains treatment as under current law. Beginning in 2013, these percentages shift to 75% treated as ordinary income and 25% eligible for capital gains treatment. In addition, the applicable percentage of income and gain subject to ordinary income tax treatment will also be subject to self-employment tax.

Despite attempts by some in Congress to carve-out certain types of investment funds from the legislation, new Section 710 applies to carried interests in all types of investment funds, including private equity, venture capital, real estate and hedge funds.

The key elements of the provisions of the Act affecting carried interest taxation are:

- The applicable percentage (as described above) of a partner's distributive share of net income on an "investment services partnership interest" or "ISPI" would be subject to tax as ordinary income regardless of the character of the underlying income at the partnership level. Income subject to ordinary income characterization on an ISPI would also be subject to self-employment tax. The applicable percentage of disposition proceeds upon the sale of an ISPI would also be taxed as ordinary income.

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- An ISPI is defined as any interest in a partnership which is held (directly or indirectly) by any person who, at the time the person acquired the interest in the partnership, is reasonably expected to provide a substantial quantity of certain enumerated investment-related services with respect to the investment assets of the partnership. Importantly, as mentioned above, no distinction is made in the legislation between types of investment funds.
- Partial ordinary income treatment does not apply to certain allocations of income and gain with respect to a "qualified capital interest" in an investment partnership. A "qualified capital interest" is generally the portion of a partner's interest attributable to capital actually contributed to the partnership with adjustments for certain income allocations and distributions with respect to the partnership interest. For example, if the general partner contributes 1% of partnership capital, allocations of gain to the general partner that are the same as allocations to limited partners who contribute 1% of partnership capital will not be subject to ordinary income treatment under the Act. In addition, additional gain allocated to the general partner resulting from the fact that the general partner does not charge itself management fees or carry will not be subject to the Act's ordinary income treatment. Partnership interests received in connected with management fee waivers would, however, be considered ISPIs subject to ordinary income treatment under the Act in the same manner as carried interests.
- For purposes of determining whether, and the extent to which, a service provider has contributed invested capital to a partnership, the proceeds of loans or other advances made or guaranteed by the partnership or any partner in the partnership are not treated as invested capital. For example, an arrangement whereby limited partners fund 20% of their commitments to the fund in the form of a loan to the general partner, the proceeds of which are contributed by the general partner to the fund for a 20% interest in the fund, would be subject to ordinary income characterization under the Act in the same manner as traditional carried interest.
- For purposes of rules applicable to publicly traded partnerships, the Act provides that the portion of income or gain treated as ordinary income with respect to an ISPI will not constitute "qualifying income." The result of this provision is that publicly traded partnerships that earn income attributable to carried interests in underlying investment funds will be classified as corporations for federal income tax purposes and thus be subject to tax at the entity level. The publicly traded partnership provision, however, will not be effective for ten years, both in the case of existing publicly traded partnerships and partnership that are not yet publicly traded.

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