H3GM
HARWELL HOWARD HYNE GABBERT & MANNER, P.C.

The Carried Interest Rule: Proposed Tax Changes for Partnerships or Limited Liability Companies

By Wm. Jay Harrelson

The U.S. House of Representatives recently passed the American Jobs and Closing Tax Loopholes Act of 2010. Although the bill has become bogged down in the Senate over unrelated issues, most observers believe that the bill will pass the Senate with some modifications. The bill includes several important provisions that significantly change the tax consequences of investments in partnerships by service partners. The following article outlines the proposed changes to the taxation of carried interest and the share of gains that fund managers and other service partners are paid as part of their compensation.

The Carried Interest Rule - Ordinary Income vs. Capital Gains

Currently, the IRS taxes carried interest based on the underlying character of the income at the partnership level. This means that upon sale of a capital asset by the partnership, the IRS taxes the gain for a service partner at the capital gains rate of up to 15% (20% after 2010). The House version of the bill re-characterizes how the IRS taxes carried interest by reallocating a large percentage of what would otherwise be taxed as capital gains as ordinary income and taxed at a rate of up to 35% (36% after 2010). The bill as passed by the House provides a blended rate so that when it is fully phased in for 2013, would treat 75% of the carried interest as ordinary income and the remaining 25% as capital gains. Additionally, any amounts treated as ordinary income under the bill would also be subject to the self-employment tax (FICA and Medicare taxes). The carried interest provisions of the bill would apply to all taxable years beginning after the date of enactment, but there is a two-year phase period. For calendar year taxpayers, the effective date would be January 1, 2011. Between 2011 and 2013, the percentage treated as ordinary income would be 50% and the remaining 50% would be treated as capital gains.

The Carried Interest Rule – Inclusions

Under the bill, carried interests of service partners, including so-called "fee waiver" or "management profits interests," are subject to the new rules and a portion of the income would be taxed as ordinary income. The bill applies to a wide range of investments or "specified assets," including private equity funds, hedge funds, venture capital funds, real estate investments (whether for rental or investment), oil and gas funds, partnerships, commodities, and options or derivative contracts. However, the language of the bill is sufficiently broad to catch other types of partnerships, such as holding companies, in its net.

The rules apply to any investment that is an "investment service partnership interest," which is defined as any partnership interest held by a person (or related person) who performs substantial services relating to the partnership assets of:

- giving advice relating to investing in, purchasing, or selling any specified asset;
- managing, acquiring, or disposing of any specified asset;
- arranging financing for specified assets; and
- providing any support activity related to the above listed activities.

The Carried Interest Rule - Qualified Capital Interest Exclusions

The bill does exclude certain interests, called "qualified capital interests" from its coverage. A qualified capital interest means an interest attributable to the fair market value of the money or property that was contributable to the partnership. For this purpose, the qualified capital interest must not be entitled to any preferential allocations with respect to the service partner to which other qualified capital interests are not entitled. The IRS can issue guidance that would permit a partner's interest to be bifurcated for purposes of applying this rule, but until it does so, any special allocation to the service partner would cause his entire interest to lose treatment as a qualified capital interest. Hopefully, the IRS will issue such guidance before the effective date of the bill.

The bill is not clear how loans affect a "qualified capital interest," although it does provide that the IRS will not treat a partnership interest as a qualified capital interest if acquired with the proceeds of a loan that is made or guaranteed (directly or indirectly) by any other partner.

The Carried Interest Rule - Losses

The bill limits the use of partnership losses to the cumulative net income of the partnership. For this purpose, partnerships can only count net income from the effective date of the bill. The re-classification to ordinary income also applies to any gain or loss realized upon the sale or disposition of the partnership interest. Although partnership interests can carry forward net losses, no basis adjustment is allowed with respect to such losses. This would appear to mean that if the partnership interest is sold while there is a net loss, such net loss cannot be used to reduce the partner's gain, if any, on the sale.

The Carried Interest Rule - The Senate's Bill

The Senate is now considering the legislation, and most observers believe that the bill will eventually pass the Senate. However, the Senate bill makes the following changes to the proposed rules:

- it keeps the amount of carried interest re-characterized as ordinary income at 75%, but makes the change effective for tax years beginning on or after January 1, 2011 without the two-year phase in period;
- it re-characterizes the amount treated as ordinary income for a gain attributable to the sale of an asset for 5 or more years to 50%;

- it applies the lower re-characterization percentage (i.e., 50%) to the gain or loss attributable to the underlying assets held for 5 or more years when a partnership interest is sold; and

- it exempts certain sales of interests in energy related publicly traded partnerships from the re-characterization rules.

Service partners and members should carefully review any partnership or limited liability company operating agreement to determine the bill's impact and analyze it to determine if any changes are appropriate to the agreement before January 1, 2011. If you would like to discuss how the American Jobs and Closing Tax Loopholes Act of 2010 impacts your business, you can contact Jay Harrelson (615-251-1090).