Carried Interest Language Narrowed, but Remains Far-Reaching

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This newsletter summarizes the Obama administration's recent carried interest tax provision. The provision is not expected to be enacted soon, but the proposal contains drafting changes of interest to those following the discussion.

On September 12, 2011, President Obama submitted to U.S. Congress legislative text for the American Jobs Act, including a revised version of the carried interest tax provision that has been introduced several times since 2007. The latest provision is unlikely to be enacted soon, but gives an indication of the form that ultimately enacted legislation may take. The latest language appears narrower than prior versions, but remains potentially applicable to more taxpayers and transactions than one would expect from the announced purpose to treat the carried interest income of investment fund managers as ordinary income subject to self-employment tax.

General Approach Continues

The latest provision would add a new Section 710 to the Internal Revenue Code. New Section 710 would continue to create a new defined term called an Investment Services Partnership Interest (ISPI). It also continues to provide that a partner's income from holding or disposing of an ISPI is ordinary and subject to self-employment tax, even if it would be capital gain and not subject to self-employment tax under general tax rules.

The latest provision also continues to apply to all partnership interests, not just interests received for services or otherwise disproportionate to capital, unless a Qualified Capital Interest (QCI) exception applies. The QCI exception continues to apply only to a class of equity that is held by persons who do not provide any services to the partnership *and* are not related to the partner holding the ISPI. There is no exception for completely *pro rata* partnerships, as there was in the most recent prior version.

ISPIs Defined More Narrowly

Prior versions defined an ISPI as any partnership interest where the holder was expected to provide services regarding the acquisition, financing, management and disposition of securities, real estate and partnership interests, referred to as Specified Assets. The latest proposal limits the ISPI definition to partnerships in which "substantially all" of the assets are Specified Assets; the holder owns the partnership interest in connection with a business that “primarily involves” the acquisition, financing, management and disposition of Specified Assets; and more than half the contributed capital of the partnership is contributed by persons who hold their partnership interests for the production of income. The “production of income” requirement appears intended to imply that the interest is not held as part of a business. This change may exclude partnerships that conduct operating businesses, and partnerships in which more than half the owners are involved in the business.

The ISPI definition attributes a business of one member of a corporate group to all others. This provision may be intended to remove most corporate internal partnerships and external joint ventures from becoming subject to the rules.

The limitation of the ISPI definition to partnerships in which substantially all of the assets are Specified Assets may remove the so-called enterprise value of some investment fund managers from ordinary income treatment. The fund manager’s carried interest from funds it operates would be ordinary, but a gain attributable to the enterprise value of the fund manager itself might qualify as capital gain.

No Loss Deferral

Prior versions of the carried interest legislation deferred all losses from an ISPI. This provision is dropped from the most recent legislation.

Disposition Provisions Narrowed Somewhat

The proposed legislation continues to require recognition of ordinary income in normally tax-free transfers. The proposal continues the exception for contributing an ISPI to another partnership if an election is made to treat the resulting partnership interest as an ISPI. The proposal adds an exception for some gifts and charitable contributions. However, other tax-free transactions including corporate contributions and mergers where ISPIs are among the assets would be taxable to the extent of the gain inherent in the ISPIs.

Publicly Traded Partnership Provisions Deferred 10 Years

The proposed legislation provides that publicly traded partnerships with income from ISPIs could continue to be publicly traded pass-through entities for 10 years after enactment.

Exceptions and Phase-Ins Removed

Unlike some prior versions of the legislation, the latest version would apply to 100 percent of ISPI income beginning January 1, 2013. The legislation does not contain an exception or a reduced rate of recharacterization for the disposition of ISPIs held more than five years.

The proposal does not contain exceptions for *pro rata* partnerships or family farms. The *pro rata* partnership exception was thought to exclude family partnerships that could not use the QCI exception because all partners are related. It is unclear whether family partnerships and family farms would avoid the provision due to the narrowing of the ISPI definition described above.