ALERTS AND UPDATES

Long-Anticipated "Carried Interest" Tax Legislation Moves Closer to Reality

June 17, 2010

This Time, Congress Seems Like It Means It

On May 28, 2010, the U.S. House of Representatives passed the American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213). Among other things, the act would add a new provision—Code Section 710 ("Proposed Carried Interest Legislation")—that would tax (or, in the case of individuals, would tax a certain percentage of) the "net income" from, and the gain from the disposition of, certain types of partnership "carried interests" as ordinary income and subject such net income and gain to self-employment tax. The U.S. Senate is now considering this legislation.

Under the Proposed Carried Interest Legislation:

1. The capital gain allocable to, and resulting from the disposition of, certain types of partnership "profits interests" and other "carried interests"—or, in the case of an individual, 50 percent of such capital gain if so allocable or recognized after December 31, 2010, and before January 1, 2013, and 75 percent of such capital gain if so allocable or recognized after December 31, 2012—would be taxed as ordinary income (and, further, would be subject to "self-employment tax"). After initially proposing that the percentage of the post–December 31, 2012 capital gain that would be taxed as ordinary income and subject to self-employment tax be reduced to 65 percent (55 percent in the case of capital gain attributable to the sale of assets held for at least seven years), the Senate Finance Committee Chairman Max Baucus introduced a substitute amendment on June 16, 2010 that would require that 75 percent of such capital gain be taxed as ordinary income beginning on January 1, 2011 (50 percent in the case of capital gain attributable to the sale of assets held for at least five years, as well as capital gain attributable to section 197 intangibles of a partnership whose principal activity is providing investment management services with respect to its assets when the partnership interest is held for at least five years). This substitute amendment would also exempt from ordinary income re-characterization (under Code Section 751) the portion of a non-service provider's capital gain from the sale of an interest in any publicly traded partnership attributable to such partnership's investment services partnership interest.

   Under current tax law, a "carried interest" (generally, a partnership interest issued for services, rather than capital) is considered an interest in the partnership (and a holder of such interest is considered a partner), much the same as a holder of a partnership interest issued for capital, except that the holder of a "carried interest" would not receive any "capital account" credit for the value of the services with respect to which the carried interest was issued or granted). Thus, under current tax law, a holder of a "carried interest" would generally be taxed on the holder's allocable share of the partnership's "long-term capital gain" in respect of, and the holder's "long-term capital gain" resulting from the disposition or redemption of, the "carried interest" at the preferential capital gains tax rate (rather than at ordinary income-tax rates) and with none of such gain being subject to self-employment taxes.

2. The type of "carried interest" that would be subject to the new legislation—referred to as an "investment services partnership interest"—would be a partnership interest (or portion thereof) held (directly or indirectly) by any person

where it was reasonably expected (at the time the person acquired the interest) that the person (or any "related person" thereto) would provide (directly or indirectly) a substantial quantity of any of the following services with respect to assets held (directly or indirectly) by the partnership: (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"; or (iv) any activity in support of any of the foregoing services.

A "specified asset" would be broadly defined to include:

- *"securities"—e.g.*, corporate stock, partnership/beneficial ownership interest in widely held or publicly traded partnership/trust, debt, interest rate, currency or equity notional principal contract, evidence of interest or derivative financial instrument (including options, forward contracts, short positions) in any of the foregoing or in any currency or any clearly identified hedge position of any of the foregoing;
- *rental or investment real estate holdings*;
- *partnership interests*;
- *"commodities"—e.g.*, any "actively traded" commodity (or any notional principal contract, other evidence of an interest or derivative instrument, option, forward or futures contract, short position or similar instrument or any clearly identified hedge position therein or with respect thereto); or
- *options or derivative contracts with respect to any of the foregoing.*

However, a "family farm" would be excluded from this definition.

3. The new legislation appears to carve out from its reach the portion of a partner's partnership interest that is attributable to the partner's *capital* investment in the partnership (and the corresponding items of partnership income, gain, losses and deductions allocable to such portion)—a so-called "qualified capital interest." However, there may be certain situations or transactions where this might not be the case.
4. The provisions of the new legislation that would characterize net income with respect to an investment services partnership interest as ordinary income would be effective for tax years ending after December 31, 2010 (subject to certain transition rules applicable to a fiscal-year partnership). The provisions of the new legislation that would pertain to dispositions and distributions would apply to dispositions and distributions occurring after December 31, 2010. Finally, the provisions of the new legislation that would pertain to other income and gain in connection with the rendering of the types of services addressed by the new legislation would be effective on December 31, 2010.

   It is important to note that, among other things, the new legislation (as currently proposed) does not grandfather any pre–January 1, 2011 built-in gain of currently existing "carried interests" that would become subject to the new legislation.

For Further Information

If you would like more information about this *Alert*, please contact any member of the Tax Practice Group or the attorney in the firm with whom you are regularly in contact.

As required by United States Treasury Regulations, you should be aware that the foregoing highlights of the new legislation is not intended to be used, and it cannot be used, for the purpose of avoiding penalties under United States federal tax laws.