CLIENT ALERT

Proposed Legislation To Tax "Carried Interests" as Ordinary Income

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The American Jobs Act of 2011 ("AJA"), submitted by President Obama to Congress on September 12, 2011, would subject income received with respect to certain partnership profits interests, or "carried interests," to ordinary income rates and self-employment tax. The basic approach of the legislation is to tax income from the performance of investment services as compensation, while still allowing favored tax treatment for interests resulting from actual capital investments by the partner performing the services, so long as that partner is treated similarly to other partners with respect to such a capital interest.

Under current law, income allocated to a carried interest has the same tax character as the income had when earned by the partnership, and it is not subject to employment taxes. For a private equity fund, such income is generally long-term capital gain or qualifying dividend income, subject to lower rates (currently 15%). The carried interest proposal in the AJA is similar to those introduced in the last several years. Notably, however, the AJA would tax 100% of the income at ordinary income rates rather than the lower percentages (50% or 75%) in the previous proposals. The carried interest proposal generally would apply to taxable years ending after December 31, 2012, and is estimated to raise $18 billion over ten years.

Prospects for passage, as with earlier proposals, are uncertain at best.

Ordinary Income Treatment

Specifically, new section 710 of the Internal Revenue Code of 1986 ("Code") would tax net income allocated with respect to an "investment services partnership interest" ("ISPI"), as defined below, as ordinary income. Any dividend income allocated to any ISPI would not be eligible for either the special 15% rate for qualifying dividends or the dividends received deduction.

Generally, any net gain on disposition of an ISPI would be recognized and also would be treated as ordinary income. There are a few exceptions: no gain would be recognized as a result of a disposition of the ISPI by gift, a transfer by death, or in certain circumstances a contribution to a partnership in exchange for an interest in that partnership. Any loss on the disposition of an ISPI would be treated as ordinary loss to the extent of any net income treated as ordinary income under section 710 with respect to the ISPI.

Finally, a partner receiving a distribution of property by a partnership with respect to an ISPI will recognize gain (treated as ordinary income) equal to the excess of the fair market value of the property at the time of distribution over the basis of the property in the hands of the partner immediately before the deemed gain recognition. The tax basis of the distributed property would then be increased to its fair market value.

As discussed below, this ordinary income treatment will not apply to "qualified capital interests."

Self-Employment Tax

The AJA would treat "investment services partnership income or loss" as self-employment income subject to Social Security and Medicare taxes. Investment services partnership income or loss is defined as the net of (A) the amounts treated as ordinary income or loss on disposition of an ISPI; (B) all items of income, gain, loss, and deduction allocated to such interest; and (c) the amounts treated as realized from the sale or exchange of property other than a capital asset under section 751 with respect to such ISPI.
The self-employment tax will not apply to income allocated with respect to "qualified capital interests."

Investment Services Partnership Interest

The new rules discussed above only apply to an ISPI. An ISPI is defined as any interest in an "investment partnership" acquired or held by a person in connection with the conduct of a trade or business that is conducted by such person or a related person and that "primarily involves" the performance of certain services with respect to the assets held by the investment partnership:

- Advising on investing in, purchasing or selling any "specified asset";
- Managing, acquiring, or disposing of any specified asset;
- Arranging financing with respect to acquiring specified assets; or
- Any activity in support of any of the foregoing.

An "investment partnership" is any partnership if, at the end of a calendar quarter beginning after December 31, 2012, (i) substantially all of the assets of the partnership are specified assets (determined without regard to goodwill and certain other intangible assets), and (ii) more than half of the contributed capital of the partnership is attributable to contributions of property by one or more persons in exchange for interests in the partnership which constitute property held for the production of income.

"Specified assets" are securities (as defined in Code section 475(c)(2)), real estate held for rental or investment, interests in partnerships, commodities (as defined in section 475(e)(2)), cash or cash equivalents, or options or derivative contracts with respect to any of the foregoing.

Qualified Capital Interests

As noted above, the AJA ordinary and self-employment income tax treatment would not apply to income allocated to a "qualified capital interest" if (A) allocations of items are made by the partnership to such qualified capital interest in the same manner as such allocations are made to other qualified capital interests held by partners who do not provide any investment services and are not related to the partner holding the qualified capital interest, and (B) the allocations made to such other interests are significant compared to the allocations made to the qualified capital interest.

Allocations with respect to a qualified capital interest are not disqualified merely because they represent a lower return than the allocations made to the other qualified capital interests or merely because they do not reflect the cost of investment services performed by the partner or a related person.

A qualified capital interest is the portion of a partner's interest in the capital of a partnership attributable to (i) the fair market value of any money or other property contributed to the partnership in exchange for such interest (determined without regard to Code section 752(a)), (ii) the amounts which have been included in gross income under Code section 83 with respect to the transfer of such interest, and (iii) any net income taken into account under Code section 702 with respect to such interest. The qualified capital interest is reduced by distributions made and allocations of net loss taken into account under Code section 702 with respect to such interest.

An ISPI is not treated as a qualified capital interest to the extent that the interest is acquired in connection with the proceeds of any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or any person related to either), unless the loan or advance is repaid before January 1, 2013.

Other Income and Gain in Connection with Investment Management Services

The AJA also provides for ordinary income treatment for income or gain earned by a person providing "investment management services" for any "investment entity" if the person holds a "disqualified interest" with respect to such entity and the value of the interest (or payments thereunder) is substantially related to the amount of income or gain from the assets with respect to which the services are performed.

A "disqualified interest" is generally an interest (other than certain debt) in a foreign corporation unless substantially all of the foreign corporation's income is either subject to U.S. federal income tax or a "comprehensive foreign income tax." "Investment management services" are the same services described above with respect to an ISPI.

Increased Penalty

The AJA increases the underpayment penalty from 20% to 40% for underpayments attributable to the application of Treasury Regulations or other guidance prescribed under Code section 710 to prevent the avoidance of section 710. An exception to the penalty would apply if (i) the taxpayer adequately discloses the relevant facts affecting the tax treatment of the item, (ii) there is substantial authority for such treatment, and (iii) the taxpayer reasonably believed that its position was more likely than not to be correct.

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