

CLIENT ALERT

Tax Reform in Small Bites: Carried Interest Changes

Jan.29.2018

This is one in a series of articles analyzing the impact of tax reform on investment funds and their portfolio companies. [Click here](#) to see all articles in the series.

Although Congress has been considering changing the tax treatment of carried interest for years, the Tax Cuts & Jobs Act (TCJA) enacted in December 2017 left the favorable treatment largely intact. The new danger to carried interest tax treatment may come from the states.

A carried interest is an equity interest in a partnership granted to a manager (or other service provider) that is not subject to tax upon grant or vesting and which often results in capital gain treatment for the holder. Managers of funds and executives in other businesses structured as partnerships for tax purposes often receive carried interest as compensation for services performed in the management of the partnership. As a result, their share of partnership income has the same character as it has for passive investors in the fund (*e.g.*, generally capital gains for private equity funds), and their proceeds from sale of their interest may largely be subject to a top 23.8 percent capital gain rate rather than the top 37 percent ordinary income tax rate for federal income tax purposes.

The TJCA imposes a new three-year holding period on certain carried interests for holders to qualify for the long-term capital gains rate. The three-year holding period applies only to a partnership interest transferred or held in connection with the provision of substantial services by the taxpayer or a related person in the trade or business of raising or returning capital and either investing in or developing “specified assets.” For this purpose, specified assets include securities, commodities, rental or investment real estate, cash or cash equivalents, and option or derivative contracts.

Having escaped federal tax reform largely unscathed, fund managers and other holders of carried interests now need to look to the states. New York Governor Andrew Cuomo announced in January that he is seeking to change the treatment of carried interest for state tax purposes and impose additional tax on hedge fund managers working in New York. It is not clear from the statement how these additional taxes would apply. Similar bills are being considered in Connecticut, New Jersey, and Massachusetts.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

Richard B. Holbrook Jr.

Partner – Washington, D.C.

Phone: +1 202.508.8779

Email: rholbrook@crowell.com