



# Tax Group Client Alert

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## CARRIED INTEREST TAX PROPOSED IN AMERICAN JOBS ACT

On Monday, September 12, 2011, President Obama submitted to Congress the American Jobs Act of 2011 (the “Act”). The Act includes a proposal to characterize certain income attributable to an investment manager’s carried interest as ordinary income, subject to the standard progressive income tax rates and self-employment taxes. The Act would apply to carried interest income earned on and after January 1, 2013. The proposal is very similar to the carried interest proposal passed by the House of Representatives in May, 2010 and described in our Client Alert dated June 1, 2010. However, unlike the prior proposal, which would have treated only a portion of carried interest income as ordinary income, the Act would treat all relevant income as ordinary. The Act would allow capital gains treatment to the extent capital gains are related to the manager’s invested capital.

The proposed treatment of income attributable to carried interests is a significant departure from current law, under which income allocated to an investment manager’s carried interest in a partnership generally has the same tax character as it has at the partnership level. In many cases (particularly for private equity, venture capital, and certain real estate funds), this entitles the manager to treat the income as long-term capital gain or dividend income, subject to favorable rates (currently 15%) and not subject to ordinary income, Social Security and Medicare taxes.

### Ordinary Income Treatment for Carried Interest

Section 412 of the Act would add section 710 to the Internal Revenue Code of 1986, as amended (the “Code”). New Code section 710 would tax net income respecting an “investment services partnership interest” as ordinary income. An “investment services partnership interest” generally is defined as any interest in an “investment partnership” that

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is held or acquired by a person in connection with that person's or a related person's conduct of a trade or business that "primarily involves" providing any of the following services to the partnership:<sup>1</sup>

- (a) Advising as to the advisability of investing in, purchasing, or selling any "specified asset."
- (b) Managing, acquiring, or disposing of any specified asset.
- (c) Arranging financing with respect to acquiring specified assets.
- (d) Any activity in support of any service described in items (a) through (c) above.

"Specified assets" include securities (as defined in Code section 475(c)(2)), rental or investment real estate holdings, partnership interests, commodities (as defined in Code section 475(e)(2)), cash or cash equivalents, and options or derivative contracts with respect to 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 partnership's assets are specified assets, and (ii) more than half of the capital contributed to the partnership is attributable to the partners' contributions of property in exchange for partnership interests which, in those partners' hands, constitute property held for the production of income.

Under the Act, gain on the sale of an investment services partnership interest (other than a "qualified capital interest," described below) is also treated as ordinary income. A net loss with respect to an investment services partnership interest or a loss on the sale of an investment services partnership interest is treated as an ordinary loss to the extent of net income previously recognized (beginning with the effective date of these rules) with respect to the partnership interest.

Ordinary income treatment can also apply when a person receives a distribution of property from a partnership in which the person holds an investment services partnership interest. Under the Act, if a partnership distributes property to a partner holding an investment services partnership interest, the partner will recognize taxable ordinary income to the extent that the fair market value of the property exceeds the partner's tax basis in the property. After the tax is computed, the person holding the investment services partnership interest will have a fair market value tax basis in the distributed property.

Amounts treated as ordinary income under Code section 710 are treated as self employment income subject to Social Security and Medicare taxes.

### **Capital Gain Treatment for "Qualified Capital Interests"**

Recognizing that persons holding an investment services partnership interest may also invest capital in the partnership, the Act would continue current law treatment of income relating 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 allocations are made to other qualified capital interests held by partners who do not provide investment services and who 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 held by the person owning the carried interest.

<sup>1</sup> The proposal does not define or provide criteria for determining when a trade or business primarily involves performing the specified services to a partnership.

A “qualified capital interest” includes the portion of a partner’s interest in the partnership attributable to

- (a) 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)),<sup>2</sup>
- (b) any amounts which have been included in gross income under Code section 83 with respect to the transfer of such interest,<sup>3</sup> and
- (c) the excess (if any) of
  - i. items of income and gain taken into account with respect to such interest, over
  - ii. any items of deduction and loss so taken into account.

An investment services partnership interest is not treated as a qualified capital interest to the extent it was purchased with proceeds of a loan or an advance directly or indirectly from, or guaranteed by, another partner (or a person related to another partner) or the partnership, unless such loan is repaid prior to January 1, 2013.

A holder’s interest would not be disqualified as a qualified capital interest solely because the interest does not reflect the costs of services that are provided to the fund by that holder or a related person. Thus, a manager’s (or a related party’s) gain respecting a capital interest in a partnership will not be treated as ordinary income as a result of the manager charging itself (or the related party) a reduced management fee or subjecting itself (or the related party) to a reduced carry on the capital interest.

### **Other Gain in Connection With Investment Management Services**

The Act also treats as ordinary income any income or gain attributable to an investment manager’s interests in a foreign corporation organized in a low tax jurisdiction.

As proposed, income or gain attributable to a “disqualified interest” is ordinary income if (a) a person performs investment management services (generally those services described above under the heading “Ordinary Income Treatment for Carried Interest”) for an entity in which it holds a disqualified interest and (b) the value of the disqualified interest is substantially related to income or gain on the assets for which the investment management services are performed.

A “disqualified interest” includes any interest other than plain indebtedness (e.g., a convertible or contingent debt obligation would be a disqualified interest) in an entity other than (a) a partnership, (b) a domestic corporation, (c) an S corporation, or (d) a foreign corporation substantially all the income of which is either (1) effectively connected with a trade or business in the U.S. or (2) subject to tax in a country that has a comprehensive income tax treaty with the U.S. or that has a comprehensive income tax (as determined by the Treasury Department).

### **Increased Penalty**

Although generally there is a 20% penalty on certain underpayments of tax, the Act increases the penalty to 40% to the extent a taxpayer’s underpayment is attributable to the application of Treasury Regulations or other guidance prescribed to prevent the avoidance of the rules relating to the taxation of carried interests and disqualified interests. The penalty would apply unless the taxpayer adequately disclosed the relevant facts, there was substantial authority for the taxpayer’s position, and the taxpayer had a reasonable belief that its treatment was more likely than not correct.

<sup>2</sup> Section 752(a) generally provides that a partner is treated as contributing money to a partnership to the extent the partner assumes partnership liabilities.

<sup>3</sup> Section 83 generally governs the timing and amount of income for individuals who receive property in exchange for performing services.

## Effective Dates

The provision characterizing net income with respect to investment services partnership interests as ordinary income would be effective beginning January 1, 2013. However, for non-calendar year partnerships, in applying the provision with respect to taxable income of a partnership for a taxable year that includes January 1, 2013, the amount of net income attributable to the investment services partnership interest would be equal to the lesser of (a) the net income for that taxable year or (b) the net income for the taxable year determined by taking into account only tax items “attributable” to the portion of the partnership’s taxable year after January 1, 2013.

The provision treating as ordinary income gain from (a) the sale of an investment services partnership interest or (b) a partnership’s distribution of property to an investment services partnership interest would be effective for distributions and dispositions occurring after December 31, 2012.

The provision relating to other income and gain in connection with investment management services is effective beginning on January 1, 2013.

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