

Milbank

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# Client Alert

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## Carried Interest Legislation Advances

On Friday, May 28, 2010, the House of Representatives passed the American Jobs and Closing Tax Loopholes Act of 2010 (the “Act”). It is not certain when the Senate will consider the legislation. 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. For individuals, the Act requires that for tax years beginning before 2013, 50 percent of the income or gain attributable to an investment manager’s carried interest be taxed as ordinary income. The percentage taxed as ordinary income increases to 75 percent for taxable years beginning on or after January 1, 2013. The Act continues to allow an investment manager 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 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), long-term capital gain or dividend income, subject to favorable rates (currently 15%) and not subject to Social Security and Medicare taxes. The Act is intended to be effective immediately after enactment, with income for the year of enactment allocated between the pre- and post-enactment portions of the tax year.

### 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” is generally any interest in a partnership which

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is held (directly or indirectly) by a person that reasonably expected (at the time of acquiring the interest) that it (or a person related to it) would provide a substantial quantity of any of the following services with respect to certain “specified assets”:

- (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,<sup>1</sup> rental or investment real estate holdings, partnership interests, commodities,<sup>2</sup> or options or derivative contracts with respect to any of the foregoing.

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 (up to the specified percentage (*i.e.*, 50 percent or 75 percent) in the case of individuals). 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, with any loss in excess of net income carried forward and treated as net loss with respect to such interest in subsequent years.

The Act also changes the manner in which a person is taxed on a distribution of appreciated 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 and the fair market value of the property exceeds the partnership’s tax basis in the property, the amount of the difference generally must be treated as ordinary income by the person holding the investment services partnership interest. The person holding the investment services partnership interest will also be treated as receiving a cash distribution from the partnership in an amount equal to the fair market value of such property and the holder will have a fair market value tax basis in the property.

The Act would apply to taxable years ending after the date of enactment. For individuals, the Act phases in ordinary income treatment. For tax years beginning before January 1, 2013, the Act requires that at least 50 percent of income allocable to an investment services partnership interest be treated as ordinary income, with income for the year of enactment allocated between the pre- and post-enactment portions of the tax year. For taxable years ending after 2012, the legislation requires that at least 75 percent of income allocable to an investment services partnership interest be taxed as ordinary income. Amounts included as ordinary income under Code section 710 are treated as self employment income subject to Social Security and Medicare taxes.

For purposes of determining whether a related person is expected to provide services, related parties are defined with reference to Code section 267 or 707(b). Generally, those rules treat people as related if they are members of the same family (as specifically defined in those sections) or have overlapping ownership in an entity in excess of 50 percent. However, the rules are extremely technical and contain elaborate constructive ownership rules. Thus, there is some concern that the rule may extend to treat unintended passive investors as related to persons providing investment services.

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<sup>1</sup> “Securities” are defined in Code section 475(c)(2).

<sup>2</sup> “Commodities” are defined in Code section 475(e)(2).

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## 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.

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>3</sup>
- (b) any amounts which have been included in gross income under Code section 83 with respect to the transfer of such interest,<sup>4</sup> and
- (c) the excess (if any) of
  - i. any 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 is 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.

An investor in a fund that also provides services to the fund is sometimes charged a reduced management fee or is subject to a reduced carry. Because allocations to such an investor are not literally made in the same manner as those made to other investors, it may appear that such an investor does not hold a qualified capital interest. However, an exception to the general rule does not disqualify a holder’s interest 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.

## OTHER GAIN IN CONNECTION WITH INVESTMENT MANAGEMENT SERVICES

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

Under the Act, 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

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<sup>3</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. “Commodities” are defined in Code section 475(e)(2).

<sup>4</sup> Section 83 generally describes the timing and amount of income for individuals who receive property in exchange for performing services.

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, (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).

## EFFECTIVE DATE

The provision characterizing net income with respect to investment services partnership interests as ordinary income would be effective for tax years ending after December 31, 2010. However, in applying the provision for taxable years that include December 31, 2010, 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 December 31, 2010.

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, 2010.

The provision relating to other income and gain in connection with investment management services is effective on December 31, 2010.

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