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Taxation of Carried Interest Legislation Nears Enactment

The movement to tax a "carried interest" as ordinary income is nearing the finish line. Late yesterday, the House released the latest version of the carried interest legislation. Both the House and the Senate plan to vote on the legislation next week and such legislation is likely to be approved.

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In general, the new legislation taxes a carried interest as follows:

- Any net income with respect to a partnership interest held by a service provider (e.g., a fund manager) to an investment services partnership (e.g., a fund) will be taxed as ordinary income. Income subject to this treatment includes a distributive share of partnership gains, gains from the disposition of the partnership interest and qualified dividends. Losses with respect to these partnership interests are treated as ordinary losses.
- An interest in an investment services partnership is an interest held by a person who performs services regarding any "specified asset" held by the partnership. In general, such services include advising with respect to investing in, purchasing or selling any specified asset, managing, acquiring or disposing of any specified asset or arranging financing with respect to any specified asset. A specified asset is generally any type of security such as stock, options, other equity interests, commodities and real estate held for rental or investment. It is unclear whether management teams of portfolio companies that receive interests in a holding partnership or LLC formed to own the portfolio companies will be subject to these rules.
- With respect to individuals, only 50% of such net income will be taxed as ordinary income for a portion of 2010, and for 2011 and 2012, 75% of such net income will be taxed as ordinary income beginning in 2013. The legislation would be effective for 2010 income realized after the date of enactment – contrary to many press reports. The portion of such individual's net income not taxed as ordinary income will be taxed as it would have been absent this new law (i.e. capital gains will be taxed as capital gains). In general, assuming that in 2011 the tax rates increase to 20% for capital gains and 39.6% for ordinary income, this means an overall effective rate on capital gains of 25% for the affected portion of 2010, 29.8% for 2011 and 2012 and 34.7% for 2013 and thereafter.
- The amount of net income that is taxed as ordinary income under this new legislation will also be subject to the self employment tax. The rate of tax on such income is currently 15.3% on the first \$106,800 and 2.9% of such income thereafter. However, beginning in 2013, the Medicare tax is increased to 3.8% on self-employment income received in excess of certain threshold amounts (\$250,000 in the case of a joint return).
- Dispositions of investment services partnership interests and distributions of property from such partnerships (e.g, distributions of stock from a fund) will generally be taxable to service providers notwithstanding that such actions will not be taxable to the other partners.
- There is an exception for certain interests treated as qualified capital interests. An interest is treated as a qualified capital interest to the extent such partner has previously paid cash or contrib-

uted property for such interest, has recognized compensatory income with respect to the receipt of such interest or has previously recognized other income with respect to the interest. In addition, any net income allocated to such qualified capital interest must be allocated in the same manner as such income is allocated to the other non-service providing partners (e.g., the limited partners) and such allocations to other partners must be significant when compared to the allocations to the qualified capital interest.

- The legislation contains language to prevent circumvention of the rules, including funding the interest by borrowing from a partner or other related party or structuring the investment through other entities such as a foreign corporation organized in a tax haven country.
- The legislation also contains a special underpayment penalty of 40% for failure to properly report any income required under these rules.

Note that the final carried interest provision may be different depending on what happens during the course of the final approval process over the next week; however, the substance is likely to be substantially the same and for that reason we wanted to get this summary to you now. We will provide further updates as developments occur.

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