House Approves Taxation of Carried Interest

Last Friday, May 28, 2010, the U.S. House of Representatives passed the American Jobs and Closing Tax Loopholes Act of 2010 (the “Act”). The Act, if passed by the Senate, would add a variety of new provisions to the Internal Revenue Code (the “Code”) that address certain tax consequences stemming from the receipt and ownership of a partnership interest by a provider of services to the partnership. This Client Alert addresses that portion of new Section 710 of the Code that would be added by the Act that generally recharacterizes as ordinary income “carried interest” that would otherwise be taxed at capital gains rates.

In particular, Section 710 would generally treat a service-provider partner’s distributive share of net income from an “investment services partnership interest” (an “ISPI”) as ordinary income except to the extent it is attributable to the partner’s “qualified capital interest.” In other words, the provision recharacterizes as ordinary income (subject to self-employment tax) such a partner’s distributive share of income from the partnership, regardless of whether that income would otherwise be treated as capital gain, dividend income or any other type of income. An “ISPI” is a partnership interest held directly or indirectly by any person if it was reasonably expected that the person, or any related person, would provide or has already provided, directly or indirectly, a substantial quantity of certain management and advisory services with respect to assets held directly or indirectly by the partnership. The services described by the provision are (i) advising on investing in, purchasing or selling any “specified asset,” (ii) managing, acquiring or disposing of any specified asset, (iii) arranging financing with respect to acquiring specified assets and (iv) any activity in support of any of the foregoing services.

For purposes of Section 710, “specified assets” mean securities, real estate held for rental or investment, interests in partnerships, commodities, or options or derivative contracts with respect to such securities, real estate, partnership interests or commodities. A security for these purposes means any (i) share of corporate stock, (ii) partnership interest or beneficial ownership interest in a widely-held or publicly-traded partnership or trust, (iii) note, bond, debenture or other evidence of indebtedness, (iv) interest rate, currency or equity notional principal contract, (v) interest in, or derivative financial instrument in, any such security or any currency and (vi) position that is not such a security and is a hedge with respect to such a security and is clearly identified. For example, assume that a private equity fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held. In these circumstances, the partnership interest is a “specified asset” for purposes of new Section 710.

As noted above, the provision contains an important exception to recharacterization as ordinary income in the case of items of income, gain, loss and deduction that are allocated to the portion of an ISPI that is a “qualified capital interest,” provided certain allocation requirements are met. Those allocation requirements are satisfied if (i) items are allocated to the service-providing partner’s qualified capital interest in the same manner as the items are allocated to other qualified capital interests of partners who do not provide any of the identified investment management services and who are not related to the service-providing partner, and (ii) the allocations made to the qualified capital interests of unrelated nonservice-providing partners are significant compared to the allocations made to the service-providing partner’s qualified capital interest.

A "qualified capital interest" is the amount of a partner's interest in partnership capital attributable to (i) the fair market value of money or other property contributed by the partner to the partnership in exchange for the partnership interest, (ii) the amount included in the partner's gross income as compensation under Section 83 of the Code with respect to the transfer of the partnership interest by the partnership for services and (iii) the partner's distributive share of cumulative net income and gain of the partnership included in the partner's income that has not been distributed by the partnership. The qualified capital interest is reduced by partnership distributions to the partner and by the partner's share of partnership losses. New Section 710 requires that a qualified capital interest take into account the foregoing amounts for taxable years prior to years to which the new provision applies.

The provision contains a variety of other rules designed to prevent planning around its recharacterization rules. For example, for purposes of the exception for qualified capital interests, an ISPI is not treated as acquired by contribution of capital by a service-providing partner to the extent of any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership. Thus, if Partner A loans Partner B funds that Partner B contributes to the partnership, the loan amount is not a qualified capital interest of Partner B. Additionally, Section 710 prescribes rules for the treatment of losses, dispositions and partnership distributions. A net loss with respect to an ISPI is treated as an ordinary loss, but is only allowed to the extent the loss does not exceed the excess of (i) aggregate net income with respect to the partnership interest for prior partnership taxable years to which the provisions apply over (ii) aggregate net loss with respect to the partnership interest not disallowed for prior partnership years to which the provision applies. Not surprisingly, on the disposition of an ISPI, gain (other than that attributable to the partner's qualified capital interest) is treated as ordinary income, notwithstanding the general rule that gain or loss from the disposition of a partnership interest is considered capital gain or loss. And, in the case of a distribution of property by a partnership to a partner with respect to an ISPI, the provision states that the partner recognizes ordinary income to the extent of any built-in gain in the property.

Significantly, the general rule recharacterizing income and loss as ordinary applies only to the "applicable percentage" of the net income or net loss. For taxable years to which the provision applies that begin before January 1, 2013, the applicable percentage is 50 percent. For taxable years beginning after December 31, 2012, the applicable percentage is 75 percent.

Section 710 is effective for taxable years ending after December 31, 2010, so calendar year partnerships may have the possibility of restructuring during 2010 to insure that some or all of a service-providing partner's partnership interest will be a qualified capital interest.

Last, but certainly not least, the Act still has to be considered by the U.S. Senate. Until recently, that house of Congress has been reluctant to embrace taxing "carried interest" as ordinary income, but rising federal deficits may overcome those concerns. As soon as the Senate completes its consideration of the Act, we will update this Client Alert.

Please contact Howard Solodky, Mark Wiley, Mike Cashin, or Jeff Lawyer if you have any questions regarding this alert.

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