

# Carried Interest Proposal to Increase Taxes on Fund Managers

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On May 28, 2010, the US House of Representatives passed H.R. 4213, The American Jobs and Closing Tax Loopholes Act of 2010 (the “Bill”). The Bill, also known as the “Tax Extenders Bill,” is principally intended to extend a number of recently expired tax incentives for a variety of corporate and individual interests. To help pay for the costs of the renewed incentives, the Bill proposes a tax increase on carried interests. The carried interest provision, if enacted by the full Congress, would dramatically increase taxation of service partners in investment funds, such as hedge funds, private equity funds, real estate funds, and venture capital funds, as well as other investment vehicles. This article describes the current status of the carried interest legislation, provides a summary of its central provisions, and notes key differences between the Bill and its Senate counterpart.

## Status of Carried Interest Legislation

The Senate took up consideration of the Bill in early June. Senate Finance Committee Chairman Max Baucus (D-MT) introduced a substitute amendment (hereinafter, the “Baucus Substitute”), which modified many aspects of H.R. 4213, including the carried interest provision. The Baucus Substitute as a whole encountered opposition in the Senate as too burdensome on the deficit, and its carried interest provision as too onerous on partnerships. Chairman Baucus modified the substitute amendment in hopes of securing the votes needed for Senate approval. On June 24, 2010, however, after the Senate failed for the third time to approve the Baucus Substitute, Senate Majority Leader Harry Reid (D-NV) indicated that he would table the bill and move on to other legislative priorities.

This turn of events by no means marks the end of the carried interest legislation. The carried interest

provision has become the revenue offset of choice among the tax committees in both the House and the Senate. A number of bills which are expected or currently pending in Congress will need revenue offsets, so the carried interest legislation is likely to reappear later this year.

## Background

A carried interest is typically a partnership interest granted to managers, sponsors or others who provide services to the partnership. The service partner may also contribute capital to the partnership, but the profits in respect of that capital contribution are generally not considered to be part of the carried interest. Because the service partner shares in the profits of the partnership in exchange for services provided, the carried interest has come to be viewed by many as similar to compensation income. Existing US tax law, however, treats carried interest profits in the same manner as the profit earned by the partnership itself. Thus, if a partnership’s activities result in capital gains, the profit allocated to the carried interest is taxed as capital gain (currently at a 15 percent rate, increasing to 20 percent in 2011), which is much lower than the ordinary income tax rate applicable to compensation income (currently up to 36 percent, increasing to 39.6 percent in 2011). In addition, under current law, profit allocated to a carried interest is generally not subject to self-employment tax.

H.R. 4213 is intended to address these perceived inequities. The Bill recharacterizes certain income allocated to service partners from “investment services partnership interests” as ordinary income. The Bill then goes far beyond income allocation, in an apparent effort to preclude service partners from



obtaining capital gain treatment for carried interest income through other means. The central provisions capturing carried interest income as ordinary income are discussed below, as are a few notable exceptions to the Bill's broad recharacterization rules.

### Investment Services Partnership Interest

The Bill defines "investment services partnership interest" broadly as any interest in a partnership which is held (directly or indirectly) by any person if it was reasonably expected (at the time that such person acquired such interest)

that such person (or any person related to such person) would provide (directly or, to the extent provided by the Secretary of the Treasury, indirectly) a substantial quantity of any of the following services with respect to assets held (directly

or indirectly) by the partnership: advising as to the advisability of investing in, purchasing or selling any specified asset; managing, acquiring or disposing of any specified asset; arranging financing with respect to acquiring specified assets; and any activity in support of these services (hereinafter, collectively, "Investment Management Services"). The term "specified asset" is defined broadly to include securities, real estate held for rental or investment, partnership interests, commodities, and options and derivative contracts with respect to any of the foregoing.

The Bill's drafters intend "investment services partnership interest" to cover any profit allocation that might reasonably be considered a carried interest, as well as to cover structures that service partners might use to circumvent the legislation. The related person language, for example, makes clear that a person will be treated as holding an investment services partnership interest even if he provides no services,

as long as a member of his family (which includes, for this purpose, his siblings, spouse, ancestors and lineal descendants) provides specified services.

Thus, transferring the carried interest to one's spouse or children will not avoid characterization as an investment services partnership interest. The related person standard includes not only family relationships, but a broad array of arrangements involving 50 percent or more overlapping ownership of entities such as corporations, partnerships and trusts.<sup>1</sup> Potentially broader is the "directly or

indirectly" language, which imposes no minimum ownership percentage.

Taken as a whole, the definition of investment services partnership interest is intended to be broad enough to reach not only manager entities, but also sponsors and

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general partners, as well as service partners in funds, manager entities, general partners and affiliates. The following exercise demonstrates the broad reach of the Bill. Consider, for example, a fund that is taxed as a partnership and is owned 1 percent by a general partner (itself a partnership) and 99 percent by several limited partners (this example does not address qualified capital interests, which are discussed below). The fund is managed by a management company that is organized as a corporation. The management company receives fees from the fund but does not own an interest in the fund. Two service partners own the general partner and the management company, in equal shares. Though the general partner is not related to the fund, the general partner entity is related to the management company, which is providing specified services. The general partner's interest in the fund therefore could be an investment services partnership interest. The service partners are, indirectly, through

the management company, providing services with respect to assets that are held indirectly by the general partner entity, through the fund, and so the service partners' interests in the general partner also could be investment services partnership interests.

It should be noted that the definition of investment services partnership interest, though broad, is not unlimited. There are narrow carve-outs. The term "specified asset" specifically excludes a family farm. Also, the Baucus Substitute provides that an investment services partnership interest will not include any interest in a partnership if all distributions and allocations of the partnership, and of any other partnership in which the partnership directly or indirectly holds an interest, are made *pro rata* on the basis of the capital contributions of each partner which constitute "qualified capital interests" (defined and discussed below).

#### **Allocations of Income and Loss**

At the core of the carried interest legislation is a provision treating income allocable to a service partner pursuant to an investment services partnership interest as ordinary income subject to self-employment tax. Thus, the Bill treats this income like compensation income, regardless of whether the income would otherwise be treated as capital gain, qualified dividend income or any other type of income. The Bill also recharacterizes the following as ordinary income subject to self-employment tax: gain on a sale of an investment services partnership interest, and unrealized gain on appreciated property distributed to a partner with respect to an investment services partnership interest. Other rules prevent the use of tiered entities and related parties to obtain capital gain treatment.

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Net losses with respect to an investment services partnership interest also are treated as ordinary, generally in an aggregate amount up to the amount of income that has been recharacterized as ordinary. Any excess net losses would be disallowed and carried forward. Disallowed losses would not result in an adjustment to the basis of a partnership interest.

For service partners that are individuals, only a portion (the "applicable percentage") of the gain or loss on an investment services partnership interest is recharacterized. Under the Bill, the applicable

percentage is 50 percent for taxable years ending after December 31, 2010, and 75 percent for taxable years beginning on or after January 1, 2013. The Baucus Substitute does not have a phase-in period,

and sets the applicable percentage at 75 percent for taxable years ending after December 31, 2010. These percentages apply to all recharacterizations of income and loss discussed in this article, except the following long-term assets: The Baucus Substitute sets the applicable percentage at 50 percent for (i) net income or loss properly allocable to gain or loss from the disposition (or distribution) of any asset which has been held by the partnership for at least five years and (ii) gain or loss on the disposition of an investment services partnership interest which has been held for at least five years, but only to the extent such gain or loss is attributable to assets held by the partnership for at least five years.

#### **Disposition of Investment Services Partnership Interest**

Under the Bill, any gain on the disposition of an investment services partnership interest is treated as ordinary income, not capital gain. Any loss on the



disposition of an investment services partnership interest is treated as an ordinary loss to the extent of the aggregate net income for all partnership taxable years to which the Bill applies over the aggregate net loss for such years. In the case of a disposition of a portion of an investment services partnership interest, the amount of net loss which otherwise would have applied to reduce the basis of such interest (but for the rule providing for no basis reduction) will be lost and will not be available for succeeding partnership taxable years.

The Bill provides an exception to the gain recharacterization rule for a disposition of an investment services partnership interest which is an interest in a publicly traded partnership, as defined in section 7704 of the Code. The exception applies if neither the individual nor any member of such individual's family (spouse, parents, children and grandchildren) has at any time provided investment management services with respect to assets held directly or indirectly by the publicly traded partnership. The Baucus Substitute revises this exception, stating that, in the case of any (direct or indirect) disposition of an interest in a publicly traded partnership which is not an investment services partnership interest in the hands of the person disposing of such interest (or the hands of the person holding such interest indirectly), such person would be exempt from the rule that recharacterizes as ordinary income that portion of the gain or loss attributable to an investment services partnership interest.

According to the Bill, ordinary income is recognized notwithstanding any other income tax provision, such as nonrecognition or deferral rules — with one exception. This exception applies where a partner contributes an investment services partnership interest to another partnership in exchange for an interest in that partnership. Notably, the new partnership interest may or may not be an investment services partnership interest. Nevertheless, to qualify for the exception, the partner must make

an irrevocable election to treat the new partnership interest as an investment services partnership interest and must agree to comply with reporting and recordkeeping requirements to be prescribed by the Secretary of the Treasury.

The Bill characterizes an investment services partnership interest held by a partnership as an inventory item of that partnership. Under existing rules, gain attributable to unrealized receivables and inventory items is treated as ordinary income. Thus, for example, upon the sale or exchange of an interest in a partnership that in turn holds an investment services partnership interest, amounts received by the transferor partner that are attributable to the investment services partnership interest could not be claimed as capital gain.

### **Partnership Distributions of Appreciated Property**

If a partnership distributes appreciated property to a service partner with respect to an investment services partnership interest, the service partner would recognize ordinary income to the extent of the built-in gain in the property. The partner's tax basis in the property would be equal to the fair market value of the property. The partner would also recognize ordinary income to the extent the value of the distributed property exceeds the partner's basis in its partnership interest. In most cases, due to adjustment of the partner's outside basis, this would not result in double taxation.

### **Qualified Capital Interests**

"Qualified capital interests" are generally not subject to the Bill's recharacterization rules, and attendant allocations would therefore still be treated as capital gain. The exception for qualified capital interests is intended to apply to capital invested by a service partner on the same terms as investments of capital by non-service partners. Accordingly, an allocation of gain to a qualified capital interest will not be recharacterized as ordinary income if (1) partnership allocations to the service partner's qualified capital interest are made

in the same manner as allocations to qualified capital interests held by unrelated non-service partners and (2) allocations to unrelated non-service partners are significant compared with the allocations made to the service partner's qualified capital interest. Similarly, on the disposition of an investment services partnership interest, a portion of which is a qualified capital interest, the portion of the gain or loss attributable to the qualified capital interest is not subject to recharacterization as ordinary.<sup>2</sup>

The Bill defines "qualified capital interest" as that portion of a partner's interest in partnership capital attributable to (1) the amount of money or fair market value of other property contributed by the partner, (2) the amount included in the partner's gross income with respect to the partner's initial receipt of the partnership interest and (3) the partner's cumulative share of net income and gain allocated to the partner but not yet distributed. However, a qualified capital interest does not include an interest acquired by a service partner with proceeds of a loan made or guaranteed, directly or indirectly, by any other partner or the partnership, or any person related to any such other partner or the partnership. The Baucus Substitute adds an important carve-out to this limitation, which is that a loan from a partner or the partnership will not disqualify a qualified capital interest to the extent the loan is repaid before the date of enactment of the carried interest legislation (unless the repayment is made with the proceeds of another loan from a partner or the partnership).

Two additional points related to "qualified capital interest" are the following: First, many service partners do not charge a carry or management fee on their own capital interests. The absence of an adjustment for carry or management fee would not, by itself, render the service partner's capital interest allocation ineligible for treatment as an allocation to a "qualified capital interest." Second, in the case of tiered partnerships, allocations pursuant to lower-tier capital interests are often passed through an upper-tier partnership to holders of capital interests

in the upper-tier partnership. As long as the capital interest in the lower-tier partnership, and attendant allocations, satisfy the rules of the Bill's "qualified capital interest" provisions, then a flow-through allocation from the upper-tier partnership will not be recharacterized as ordinary income if the items are allocated on the basis of the partners' qualified capital interests in the upper-tier partnership.

### **Other Investment Management Services Income**

The Bill treats as ordinary income certain income or gain of an investment manager that is attributable to a "disqualified interest" in a foreign corporation organized in a low tax jurisdiction.

Specifically, the Bill treats as ordinary income any income or gain with respect to a "disqualified interest" in an entity if a person performs (directly or indirectly) a substantial quantity of Investment Management Services (as defined above) for that entity, and the value of such interest (or payments thereunder) is substantially related to the amount of income or gain (whether or not realized) from the assets with respect to which the Investment Management Services are performed. A "disqualified interest" is (a) any interest other than indebtedness, (b) convertible or contingent debt, (c) any option or other right to acquire either of the foregoing, or (d) any derivative instrument entered into (directly or indirectly) with an entity or any investor in such entity, in an entity other than (i) a partnership, (ii) a domestic C corporation, (iii) an S corporation, or (iv) a foreign corporation substantially all of the income of which is (x) effectively connected with the conduct of a trade or business in the United States or (y) subject to tax in a foreign country if (A) that foreign country has a comprehensive income tax (as determined by the Secretary of the Treasury) or (B) the entity is eligible for the benefits of a comprehensive income tax treaty between such foreign country and the United States. For this purpose, the rules similar to the qualified capital interest rules, as described above, will apply.



### **New Ordinary Income Tax on Enterprise Value**

The Bill would recharacterize as ordinary income 50 percent of the gain on the disposition of an asset or investment services partnership interest held for at least five years, as discussed above. The Baucus Substitute includes intangible assets such as goodwill and going concern value related to certain entities providing investment management services. Under this new provision, if an investment services manager sells its company, in certain cases, part of the gain that is attributable to the goodwill of the business would be subject to tax at ordinary income tax rates. This provision represents a dramatic shift in the taxation of sales of businesses, and would result in investment managers being taxed at higher rates than other professionals who sell their businesses.

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### **Publicly Traded Partnerships**

The Bill is designed to change the federal tax treatment of certain publicly traded partnerships. Generally, US income tax law treats a publicly traded partnership as a corporation unless more than 90 percent of the partnership’s income is “qualifying income” (typically, passive income, such as rents, royalties, dividends and interest). The Bill provides that ordinary income from an investment services partnership interest, other than certain oil and gas income, is not “qualifying income” for federal income tax purposes. This may make it more difficult for publicly traded partnerships to avoid taxation as corporations at the federal level.

Because this provision may affect a large number of publicly traded partnerships, it will not apply until 10 years after the Bill becomes effective.

Also, there is a carve-out for certain publicly traded partnerships owned by real estate investment trusts (“REITs”). Income from an investment services partnership interest would still be “qualifying income”

for federal income tax purposes where (1) the partnership is treated as publicly traded solely because interests in the partnership are convertible into interests in a publicly traded REIT, (2) at least 50 percent of the capital and profits interests of the partnership are owned, directly or indirectly, at all times during the taxable year, by the REIT and (3) the partnership meets applicable

REIT income and asset tests.

### **Broad Delegation of Regulatory Authority**

The Bill grants Treasury unusually broad regulatory authority to prescribe regulations or other guidance to address key questions left open by the Bill. For example, the Bill leaves it to Treasury to characterize allocations to qualified capital interests where the allocations to unrelated non-service partners are not significant compared with the allocation made to the service partner’s qualified capital interest. More significantly, Treasury is also specifically directed to prescribe regulations or other guidance to prevent the avoidance of the purposes of the carried interest provisions.

### Increased Penalties

The Bill doubles the penalty — from 20 percent to 40 percent — for underpayment of tax in violation of applicable anti-abuse provisions, such as the anti-abuse regulations to be promulgated by Treasury. This penalty increase is designed to discourage the purposeful use of structures to circumvent the Bill's recharacterization rules. Under current law, a taxpayer may secure waiver of a penalty by showing reasonable belief and good faith. Under the Bill, however, waiver would be available only where (1) the facts relevant to the tax treatment are adequately disclosed on the return, (2) there is or was substantial authority for the claimed treatment and (3) the taxpayer reasonably believed that the claimed treatment was more likely than not the proper one.

### Effective Date; No Grandfathering

The Bill's carried interest provisions would apply to taxable events occurring in tax years ending after December 31, 2010. Any gain or loss realized after the Bill becomes effective would be subject to the Bill's recharacterization rules, regardless of whether the gain or loss accumulated in earlier years. In other words, there is no grandfathering for built-in gains or losses from an earlier tax year. Similarly, the Bill's recharacterization rules would apply even if the partner had discontinued his services to the partnership long before the Bill became effective.

For this reason, partners owning investment services partnership interests with significant built-in gains or losses would be well-advised to consider realizing such gains or losses before the Bill becomes effective. Built-in gains are common, for example, in investment partnerships owning depreciable property, such as real estate. The partner may have provided services to the partnership quite some time ago. In the ensuing years, significant built-in gains may have resulted from increased property values combined with basis reduction through depreciation, or significant built-in losses may have accrued due to the recent dramatic declines in property values. The tax treatment of these built-in gains and losses would change dramatically if the gains or losses were realized after the Bill becomes effective. ★

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<sup>1</sup> The related persons standard is set forth in sections 267(b) and 707(b) of the Internal Revenue Code (the "Code").

<sup>2</sup> The portion of gain or loss attributable to the qualified capital interest is determined by the ratio of (1) the distributive share of gain or loss that would have been allocated to the qualified capital interest under applicable tax provisions, had the partnership sold all its property in a fully taxable transaction for cash in an amount equal to the fair market value of the property immediately before the disposition, to (2) the distributive share of gain or loss that would have been so allocated to the entire investment services partnership interest of which the qualified capital interest is a part.



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