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ADVISORY

MAY 2010

CARRIED INTEREST TAX LAW CHANGES COULD BECOME EFFECTIVE WITHIN DAYS

UPDATE AS OF JUNE 1, 2010: *On May 28, 2010, the House passed a revised version of the American Jobs and Closing Tax Loopholes Act (HR 4213), by a vote of 215-204. The bill includes the changes to taxation of carried interests described below, but in most cases, the effective date of the legislation has been delayed until January 1, 2011, as opposed to the date of enactment. Moreover, the Senate will not take up the bill until the week of June 7, 2010. Even then, Senate Majority Leader Harry Reid (D-Nev.) has said that a series of amendments will be considered. In particular, several Democratic Senators have pushed for an exemption from the carried interest changes for venture capital. In sum, it remains unclear whether or when the carried interest tax rules will change, but if Congress does act this summer, holders of carried interests in existing or future transactions will likely have a brief window of opportunity through the end of 2010 to prepare for the tax increase.*

On May 20, 2010, Senate Finance Committee Chairman Max Baucus (D-Mont.) and House Ways and Means Committee Chairman Sander Levin (D-Mich.) released a compromise proposal on the taxation of carried interests, as part of the American Jobs and Closing Tax Loopholes Act, HR 4213 (the May 2010 Bill). This proposal will impact sponsors of various types of investment partnerships, such as US real estate funds, private equity funds and hedge funds, as well as special purpose joint ventures that invest in real estate. The new bill represents the joint position of the two chairmen, House and Senate leadership, and other key members of Congress. The House leadership currently intends to call for a vote on Tuesday, May 25, 2010, with the Senate poised to act shortly thereafter. Although a furious lobbying effort continues, there is a significant possibility that the May 2010 Bill will be approved by the House and Senate and signed into law by President Obama before Memorial Day.

Key provisions of the May 2010 Bill would be effective on the date of enactment

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(i.e., the date the bill is signed into law). Taxpayers who own carried interests may wish to consider acting now to recognize taxable gain or otherwise to restructure or plan for the possible changes in tax law that would result from enactment.

ORDINARY INCOME VS. CAPITAL GAIN RATES

Tax rates are in flux and there may be additional legislation this year that will further change the picture. Currently, however, the following maximum federal income tax rates apply to ordinary income and capital gains:

Through the end of 2010:

- Maximum Ordinary Income Rate is 35 percent
- Maximum Long-Term Capital Gain Rate is 15 percent

Beginning in 2011:

- Maximum Ordinary Income Rate is 39.6 percent
- Maximum Long-Term Capital Gain Rate is 20 percent

In addition to income taxes, Medicare taxes are relevant to this analysis. Under current law, the rates and applicability are as follows (assuming that the individual exceeds certain threshold income amounts in a given year):

Through the end of 2012:

- Net Earnings from Self-Employment are taxed at 2.9 percent
- Capital Gains or other Investment Income is not subject to Medicare tax

Beginning in 2013:

- Net Earnings from Self-Employment are taxed at 3.8 percent
- Capital Gains/Investment Income is taxed at 3.8 percent

SUMMARY OF CHANGES IN MAY 2010 BILL

Tax Rates

The May 2010 Bill generally treats income and gain that is allocable to carried interests (Carried Interest Income/Gain) on a blended basis—partly as ordinary income that is subject to self-employment tax and partly as it would have been treated under current law (often, but not always, as long-term capital gain (LTCG)). Thus:

Through the end of 2012:

- 50 percent of Carried Interest Income/Gain Treated as Ordinary Income Subject to Self-Employment Tax
- 50 percent of Carried Interest Income/Gain Treated as LTCG

Beginning in 2013:

- 75 percent of Carried Interest Income/Gain Treated as Ordinary Income Subject to Self-Employment Tax
- 25 percent of Carried Interest Income/Gain Treated as LTCG

Combining these rules with the generally applicable tax rates described above, here are the effective federal tax rates on Carried Interest Income/Gain (assuming enactment of the May 2010 Bill):

Time Period	Approx. Federal Tax Rate
Prior to Date of Enactment	15.0%
Date of Enactment - 12/31/2010	26.5%
2011–2012	31.3%
2013 and beyond	37.6%

Note that these blended tax rates assume that the underlying income or gain would have been long-term capital gain under current law.

What is "Carried Interest"?

Lawmakers generally use "carried interest" as shorthand for an investment services partnership interest (ISPI) as defined in the May 2010 Bill. The term is generally synonymous with the terms "carry", "profits interest", "promote", "performance allocation", and "incentive allocation". An ISPI is a partnership interest held by a person if it was reasonably expected at the time such person acquired such interest that such person (or a related person) would provide, directly or indirectly, a substantial quantity of one or more of several listed services with respect to the partnership's specified assets. "Specified assets" generally include securities, real estate, commodities, or options/derivatives related to the foregoing.

The covered services include advising on investing in, purchasing or selling any specified asset; managing, acquiring or disposing of any specified asset; arranging financing with respect to specified assets; or any activity in support of the foregoing services.

If a portion of an ISPI is a qualified capital interest (QCI), any income or gain that is allocable to the QCI is not treated as Carried Interest Income/Gain. In general, a QCI is the portion of a partner's interest in the capital of the partnership that is attributable to cash or other property actually contributed to the partnership in exchange for such interest, increased by net profit allocations and reduced by distributions and net loss allocations. To benefit from the special QCI rule, the holder of the ISPI must generally be allocated partnership items in the same manner as significant such allocations are made to other QCIs held by non-service partners. There are numerous important technical questions that the May 2010 Bill leaves unresolved, some of which will be addressed by Treasury Regulations or other guidance. As a result, it is difficult to generalize at this point on the utility of the QCI exception, but it should mitigate the impact of the May 2010 Bill on service partners to the extent that they invested their own equity capital alongside the other investor(s) upon formation of the partnership or upon subsequent capital calls.

Carried Interest Income/Gain Triggers

In general, the May 2010 Bill treats three categories of realized income or gain as Carried Interest Income/Gain subject to these rules:

- Partnership net income allocated with respect to the ISPI;
- Gain recognized on the sale or other disposition of an ISPI; and
- Distribution of appreciated property from the partnership to the partner in respect of the ISPI.

With one exception that was recently added in the May 2010 Bill, the second category (gain on disposition) includes any gain that is normally tax-deferred under other tax principles. For example, if a partner transfers an ISPI to a newly formed corporation in exchange for 100 percent of the corporation's stock, that would normally be a tax-deferred transaction under Code Section 351. The May 2010 Bill overrides Section 351 and taxes the contributing partner immediately. The new exception is that a partner may transfer an ISPI to another partnership without recognizing gain, but only if the partner irrevocably elects to treat the partnership interest received in the exchange as an ISPI.

The third category (distribution of appreciated property) overrides the general rule that such distributions are not taxable under Section 731 (albeit with various exceptions). Under the May 2010 Bill, if a partner receives a distribution of appreciated property from a partnership on account of an ISPI, the partnership must recognize all of the built-in gain and allocate it to the distributee partner, who must treat that gain as Carried Interest Income/Gain.

Steeper Penalties

The May 2010 Bill grants broad authority to the US Department of the Treasury to promulgate regulations or other guidance necessary or appropriate to carry out the May 2010 Bill's purposes. That authority includes a specific charge to issue guidance to prevent the avoidance of those purposes. The May 2010 Bill also increases the tax penalties for an underpayment of tax that is attributable to the application of those regulations and guidance (when issued).

Under current law, there is a 20 percent underpayment penalty for negligence or a substantial understatement of income tax, among other categories. That penalty is waived, however, if the taxpayer shows reasonable cause and good faith. Under the enhanced penalty provisions in the May 2010 Bill, the penalty is increased to 40 percent and it is waived only if the relevant facts affecting the tax treatment were adequately disclosed, there is substantial authority for the tax treatment, and the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

Rules Apply to Pre-Enactment Built-In Gain

An important aspect of the May 2010 Bill is that there is no “grandfathering” or other special treatment for built-in gain on ISPIs. If a taxpayer owns a carried interest that was issued in consideration for services many years ago, even if the taxpayer no longer performs such services, the interest would be tainted as an ISPI and any built-in gain would be subject to recharacterization as Carried Interest Income/Gain if triggered after the effective date of the May 2010 Bill. Built-in gain is especially common in real estate partnerships and other investment partnerships that own depreciable assets, due to the use of leverage and the ability to depreciate buildings and personal property. Some partners may own ISPIs that have relatively low (or zero) current fair market value but that have significant built-in gain due to negative capital accounts.

For all of these built-in gains, the tax treatment would change instantly and dramatically on the effective date of the May 2010 Bill. Many tax-deferred transactions the day before enactment could be subject to a 26.5 percent federal tax rate the next day. Even outright taxable sales could have an increase in federal tax rate from 15 percent to 26.5 percent, further increasing to 31.3 percent on January 1, 2011 and 37.6 percent on January 1, 2013.

Under these circumstances, partners holding carried interests with significant built-in gain may wish to consider acting prior the effective date of May 2010 Bill.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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