

Carried Interest Tax Provisions of the American Jobs and Closing Tax Loopholes Act of 2010

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The House of Representatives passed H.R. 4213, the “American Jobs and Closing Tax Loopholes Act of 2010” (the “Bill”), on Friday, May 28, 2010. The Senate is expected to vote on a similar or identical version of the Bill soon, after it returns from the Memorial Day Recess on Monday, June 7, 2010.

The Bill includes carried interest provisions that would tax a partner’s net income from certain carried interests as ordinary income subject to self-employment tax and any net loss (to the extent not disallowed, as discussed further below) from carried interests as ordinary loss. This includes net income or gain from dispositions (including those that are otherwise nontaxable dispositions under present law federal income tax principles). For individuals, only a portion of net income and net loss is recharacterized: 50% after December 31, 2010 and before January 1, 2013, and 75% beginning January 1, 2013.

Generally, a carried interest is a partnership interest provided to a developer, manager, sponsor or other service partner (a “service partner”) to share in profits of the partnership without the contribution of capital by the service partner. In many investment partnerships, the service partner receives a 2% management fee based on the partnership’s net asset value plus a 20% share of profits, known as a “2 and 20” structure. The carried interest provision of the Bill is aimed at the 20% share of profits, or carried interest, portion of the 2 and 20 structure. The carried interest provision of the Bill is new Section 710 of the Internal Revenue Code of 1986, as amended (the “Code”). There are no carve outs for specific industries although some members of the House and Senate have indicated that an exception for venture capital firms must be included.

Code Section 7704(d)(6) - Exception for Certain Publicly Traded Partnerships

The provisions of new Section 7704(d)(6) generally provide that items of income and gain that are recharacterized as ordinary income by reason of new Section 710 are not treated as qualifying income of a publicly traded partnership for taxable years beginning on or after the date that is 10 years after enactment. However, this general rule does not apply to treat as non-qualifying any income of a publicly traded partnership that otherwise qualifies under the natural resource exceptions of Section 7704(d)(1)(E). Thus, income and gains from activities relating to oil, gas, other natural resources, and other items so described are not treated as other than qualifying income by reason of being recharacterized as ordinary income.

The provision also provides a special rule for partnerships owning certain other publicly traded partnerships. The general rule that items of income and gain that are ordinary income by reason of new Section 710 are not qualifying income of a publicly traded partnership does not apply in the case of a partnership substantially all of the assets of which consist of interests in one or more publicly traded partnerships that are traded on an established securities market (such as the New York Stock Exchange) and substantially all of the income of which is ordinary income or Code Section 1231 gain (generally, gain from the sale or exchange of property used in a trade or business).

The qualifying income provision provides a special rule for partnerships that are owned by publicly traded real estate investment trusts (“REITs”). Under the special rule, the general rule that items of income and gain that are ordinary income by reason of new Section 710 are not qualifying income of a publicly traded partnership does not apply, provided:

- the partnership is treated as publicly traded solely by reason of interests in the partnership being convertible into interests in REIT which is publicly traded;
- 50% or more 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
- the partnership itself satisfies the income and assets tests applicable to a REIT.

Code Section 710 - Carried Interest Provision

Phase-In of Code Section 710

The carried interest provision of the Bill is to be phased in under a transition rule prior to January 1, 2013. *In the case of an individual*, after December 31, 2010 and before January 1, 2013, 50% of net income from an investment services partnership interest or gain from the disposition of an investment services partnership interest is taxable as ordinary income under Code Section 710 and 50% of such net income or gain continues to be taxable under present law federal income tax principles. *In the case of an individual*, beginning January 1, 2013, 75% of net income from an investment services partnership interest or gain from the disposition of an investment services partnership interest would be taxable as ordinary income under Code Section 710 and 25% of such net income or gain would continue to be taxable under present law federal income tax principles. In the discussion below, “specified percentage” refers to 50% or 75%, as applicable, in the case of individuals and 100% in the case of other types of service partners.

Net Income and Net Loss from an Investment Services Partnership Interest

New Code Section 710 provides that a service partner’s specified percentage of its distributive share of net income from an “investment services partnership interest” is treated as ordinary income and the specified percentage of its distributive share of net loss from an investment services partnership interest is treated as ordinary loss, to the extent not disallowed. The specified percentage of net loss is allowed only to the extent that such loss does not exceed the excess of (i) the service partner’s specified percentage of its distributive share of aggregate net income with respect to such interest for all prior partnership taxable years ending after December 31, 2010, over (ii) the service partner’s specified percentage of its distributive share of aggregate net loss with respect to such interest not disallowed under this rule for all prior partnership taxable years ending after December 31, 2010. For a prior taxable year that includes but does not end on December 31, 2010, a service partner’s distributive share of net income is the lesser of (i) net income for the entire partnership taxable year, or (ii) the net income determined by only taking into account items attributable to the portion of the taxable year after December 31, 2010.

A service partner may carry forward disallowed net loss to be used in a succeeding taxable year and the disallowed net loss does not affect (i.e., does not reduce) the service partner’s adjusted basis in the investment services partnership interest. A service partner’s distributive share of net income and net loss for purposes of Code Section 710 otherwise is determined under present law federal income tax principles. The specified percentage of any dividend taken into account in determining a service partner’s distributive share of net income or net loss does not qualify for the preferential federal income tax rates applicable to “qualified dividend income” under present law federal income tax principles.

An “investment services partnership interest” means any interest in a partnership which is held directly or indirectly by a 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 indirectly, a substantial quantity of any of the following services (“investment management 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; or
- any activity in support of any service described in the three preceding bullet points.

A “specified asset” means securities (such as stock in a corporation, units in a publicly traded partnership and debt instruments), real estate held for rental or investment, interests in partnerships that are not otherwise treated as securities, commodities (including oil or gas) or options or derivative contracts with respect to any of the foregoing.

Disposition of an Investment Services Partnership Interest

The term “disposition” is not defined in the Code or Treasury regulations but such term generally is defined using its commonly understood and very broad meaning: the act of transferring something to another’s care or possession, especially by deed or will; the relinquishing of property.

Subject to an exception for certain individuals holding an interest in a publicly traded partnership discussed below, the specified percentage of gain from the disposition of an investment services partnership interest is treated as ordinary income and except for a limited exception discussed below, must be recognized notwithstanding any other federal income tax provision of the Code, such as nonrecognition or deferral provisions. The specified percentage of loss from the disposition of an investment services partnership interest is treated as ordinary loss, to the extent not disallowed. Any loss from a disposition of an investment services partnership interest is allowed only to the extent of the excess of (i) the service partner’s specified percentage of its distributive share of aggregate net income with respect to such interest for all partnership taxable years ending after December 31, 2010, over (ii) the service partner’s specified percentage of its distributive share of aggregate net loss with respect to such interest for all partnership taxable years ending after December 31, 2010. However, as noted above for a partnership taxable year that includes but does not end on December 31, 2010, a service partner’s distributive share of net income is the lesser of (i) net income for the entire partnership taxable year, or (ii) the net income determined by only taking into account items attributable to the portion of the taxable year after December 31, 2010.

Disposition by an individual of an investment services partnership interest which is an interest in a *publicly traded partnership* is not subject to the recharacterization rules of Code Section 710 if neither the individual nor any member of such individual’s family (spouse, adopted or biological children, grandchildren, and parents) has at any time provided investment management services with respect to assets held directly or indirectly by such publicly traded partnership. Additionally, gain realized from contribution of an investment services partnership interest to a partnership in exchange for a partnership interest is not subject to immediate recognition under Code Section 710 if (i) the transferor makes an irrevocable election to treat the partnership interest received as an investment services partnership interest and (ii) the transferor partner agrees to comply with certain reporting and recordkeeping requirements set forth by Treasury or the Internal Revenue Service.

Net Income and Net Loss from a Qualified Capital Interest

Net income and net loss from a portion of an investment services partnership interest that is a capital interest in the partnership attributable to

- money or property contributed to the partnership (not including any deemed contribution under Code Section 752(a)),
- gross income recognized under Code Section 83 (i.e., for performing services) with respect to the transfer of such interest, and
- the distributive share of net income and gain of the partnership with respect to such interest that has not been distributed by the partnership

(a “qualified capital interest”) is exempt from the provisions of Code Section 710 that recharacterize such net income or net loss as ordinary income or ordinary loss. Contributions of appreciated property must be properly accounted for in the qualified capital interest. The qualified capital interest is reduced by partnership distributions with respect to such interest and by the service partner’s distributive share of net loss, if any.

Net income or net loss from such a qualified capital interest would continue to be characterized under present law federal income tax principles, whether that would be as capital gain or loss or ordinary income or loss. In order for a service partner’s partnership interest to qualify as a qualified capital interest, (i) allocations of items must be made to the qualified capital interest in the same manner as such allocations are made to other qualified capital interests held by partners who do not provide investment management services and who are not related to the service partner (the fact that allocations may represent a lower return for the service partner than allocations to the other partners is not itself determinative), and (ii) the allocations made to such other interests must be significant compared to the allocati

ons made to the service partner's qualified capital interest. Treasury is authorized to promulgate regulations or guidance that will allow qualified capital interest treatment for a service partner's partnership interest in certain situations where allocations to the other partners are not "significant." In tiered partnerships, all items allocated to qualified capital interests in a lower-tier partnership retain such character to the extent allocated on the basis of qualified capital interests in the upper-tier partnership.

A qualified capital interest does not include an interest acquired by a service partner in connection with the proceeds of any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or a person related to that other partner or the partnership).

In the case of a partner that holds a qualified capital interest in a partnership and provides services with respect to assets held directly or indirectly by the partnership, the qualified capital interest will be converted to an investment services partnership interest if such services change to investment management services.

Disposition of a Qualified Capital Interest

On the disposition of an investment services partnership interest, any portion of which is a qualified capital interest, a proportionate amount of the gain or loss attributable to the qualified capital interest is not subject to recharacterization as ordinary income. The proportionate amount of the gain or loss attributable to the qualified capital interest is determined generally by the ratio of gain or loss on liquidation of the service partner's qualified capital interest to the gain or loss on liquidation of the service partner's entire investment services partnership interest, as if the liquidation occurred immediately before the disposition.

Partnership Distributions

Generally, for property that has appreciated in value in the hands of a partnership, the distribution of such property by the partnership to a service partner with respect to an investment services partnership interest generates ordinary income to the service partner to the extent of the specified percentage of the appreciation as if the appreciation were a portion of the service partner's distributive share of net income. Additionally, to the extent that the fair market value of the property (which is treated as money) exceeds the service partner's adjusted basis in its partnership interest (determined after adjustment for its distributive share of net income), the service partner recognizes ordinary income on the specified percentage of such excess. The service partner's specified percentage of its basis in such property after the distribution is its fair market value at the time of distribution.

Applying present law federal income tax principles, an investment services partnership interest is treated as a "hot asset" under Code Section 710. This means that upon a partner's sale or exchange of an interest in an upper tier partnership that holds an investment services partnership interest in a lower tier partnership, the transferor partner recognizes the specified percentage of the ordinary income on amounts received that are attributable to the investment services partnership interest.

Interests in Other Entities

If a service partner, directly or indirectly, performs investment management services for an entity other than a partnership, holds a "disqualified interest" in such other entity and the value of such interest 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, the same investment services partnership rules set forth above apply equally to the service partner's interest in the other entity. The service partner's distributive share of net income or gain from the disposition of the interest in such other entity is treated as ordinary income. A "disqualified interest" in an entity means:

- any interest in the entity other than indebtedness;
- convertible or contingent debt of the entity;
- any option or other right to acquire property described in the preceding bullet points; and
- any derivative instrument entered into (directly or indirectly) with the entity or any investor in the entity.

A disqualified interest does not include a partnership interest, any interest in a taxable corporation (except as provided in Treasury regulations) and stock in an S corporation (except as provided in Treasury regulations).

Self-Employment Income

Any amount treated as ordinary income or ordinary loss under Code Section 710 must be taken into account by the service partner in determining its net earnings from self-employment. Any amount not treated as ordinary income or ordinary loss because it is allocable to a qualified capital interest is not taken into account.

Penalties

The penalty on an underpayment of tax attributable to the failure to comply with provisions of Code Section 710 and Treasury regulations issued thereunder employed to prevent the avoidance of the purposes of Code Section 710 (such as use of a “disqualified interest”) is 40% of the underpayment. This is an increase from a penalty of 20% of the understatement of tax for a general understatement of tax.

Effective Date

Generally, the provisions affecting carried interests under the Bill apply to taxable years ending after December 31, 2010. However, as discussed above, for a partnership taxable year that includes but does not end on December 31, 2010, a service partner’s distributive share of net income is the lesser of (i) net income for the entire partnership taxable year, or (ii) the net income determined by only taking into account items attributable to the portion of the taxable year after December 31, 2010. Further, the provisions under the Bill with respect to dispositions and distributions apply to dispositions and distributions made after December 31, 2010.

More Information

[Click here for the full text of H.R. 4213 \(PDF\).](#)

If you have any questions, please contact [Will Becker](#), [Thomas Ford](#), [Robert McNamara](#) or [Thomas Popplewell](#).

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