

Hot Issues Alerts – Law Firms

Congress Moves Closer To Taxing Carried Interest As Ordinary Income

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On Wednesday, December 9, the House of Representatives, by a vote of 241-181, passed H.R. 4213, the Tax Extenders Act of 2009 (the “Extenders Act”). This legislation would extend a number of expiring tax provisions, while raising offsetting revenue by taxing the “carried interest” of fund managers as ordinary income. The Extenders Act adopts, with only minor modifications, the carried interest tax provisions of H.R. 1935, which was introduced on April 2, 2009, by U.S. Representative Sander Levin (D-MI).

If enacted in its current form, this legislation would have a dramatic impact on the taxation of many fund managers, including managers of most private equity funds and some hedge funds. Under current law, the tax character of carried interest is determined at the partnership level based upon the character of partnership income, so that carried interest received by many investment funds is taxed at the federal long-term capital gains rate of 15 percent. The Extenders Act, if passed, would increase the federal tax on carried interest to a rate in excess of 37 percent, after factoring in employment taxes. The carried interest provisions of the bill generally would apply to tax years ending after December 31, 2009.

President Obama has indicated that he will sign the Extenders Act. It is unclear, however, if the Senate will adopt the carried interest tax provisions of this bill. Timing of enactment is also uncertain, as the Senate could pass the bill early next year, without modifying the current effective date.

Despite this uncertainty, the carried interest tax provisions, which were pre-

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viously introduced as standalone bills, appear closer to enactment than at any prior time. Accordingly, fund managers may wish to consider certain year-end tax planning strategies in anticipation of the bill's passage.

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Highlights Of Carried Interest Tax Provisions

- Interests in a partnership held, directly or indirectly, by providers (and related persons) of investment management services to that partnership are treated as “investment services partnership interests” (“ISPIs”).
- Investment management services are very broadly defined and include arranging financing for, or managing, acquiring or disposing of, securities, real estate, partnership interests, commodities or certain options or derivatives held by the partnership.
- Net income allocable to ISPIs, gain from the disposition of ISPIs, and distributions in kind of appreciated property attributable to ISPIs are taxable as ordinary income and subject to employment taxes.
- A limited exception applies to certain capital interests held by service providers.
- Provisions specifically address the use of certain loans, derivatives or offshore corporations to avoid the application of these rules.
- The Treasury Department is directed to issue anti-avoidance regulations or other guidance.
- Avoidance of these rules could result in a 40 percent penalty of the understated tax liability.

Effective Date for Carried Interest Tax Provisions

The carried interest provisions of the

Extenders Act are generally effective for taxable years ending after December 31, 2009. These provisions of the bill do not include any phase-in periods or “grandfathering” exceptions for existing partnerships.

Publicly Traded Partnership Provisions

The Extenders Act also contains a provision that income attributable to an ISPI does not constitute “qualifying income” of a publicly traded partnership. Currently, many publicly traded investment partnerships avoid corporate taxation because at least 90 percent of their gross income is qualifying income, which is generally passive income such as capital gains, dividends, interest or royalties. Accordingly, if the bill passes, a publicly traded partnership will be taxable as a corporation for federal income tax purposes if more than 10 percent of the partnership's gross income consists of income from an ISPI, because such income will not be treated as qualifying income. The bill, however, provides a 10-year grace period for existing publicly traded firms.

Modification To Section 83(b) Election Rules

In the case of a transfer, after the date of enactment, of any interest in a partnership in connection with the provision of services to or for the benefit of the partnership, the Extenders Act provides that the recipient of the partnership interest is deemed to have made an election under Section 83(b) of the Internal Revenue Code. As a result, that recipient would be taxed at issuance, unless the person affirmatively elects otherwise. Thus, absent such election, the recipient of the partnership interest must include in income for the taxable year of the transfer the fair market value (if any) of the partnership interest.

Foreign Tax Compliance Provisions

The Extenders Act also contains provisions from the Foreign Account Tax Compliance Act of 2009 (“FATCA”) to prevent U.S. persons from using foreign financial institutions, trusts and corporations to evade U.S. taxes. These provi-

sions would create an expansive and complicated reporting and withholding tax regime intended to force foreign financial intermediaries and investment vehicles to identify U.S. account holders and investors, including those investing through foreign entities with “substantial U.S. owners” (defined below). Under this regime, a 30 percent U.S. withholding tax would be imposed on the gross income from U.S. financial assets (including gross proceeds from the disposition of any property that can produce U.S. source interest or dividends) otherwise payable to a foreign financial entity, unless that foreign entity has entered into an agreement with the IRS to obtain and report information about its U.S. investors, including those investing through a foreign entity with U.S. investors that hold a greater than 10 percent direct or indirect interest in such foreign entity (referred to as “substantial U.S. owners”).

These provisions would also impose similar withholding requirements on payments from U.S. sources to a foreign non-financial entity (which could include private investment funds), unless that entity discloses to the payor the identity of all substantial U.S. owners and this information is in turn reported by the payor to the Internal Revenue Service (“IRS”).

In addition, these provisions contain additional reporting requirements for U.S. owners of foreign bank accounts and investments and make changes to penalties and the statute of limitations for failures to report.

These provisions would also treat certain “dividend equivalent” payments as dividends for tax purposes. As a result, U.S. withholding tax generally would apply to certain swap payments and other substitute payments that are economically similar to dividends but currently avoid U.S. tax.

Further, these provisions would also eliminate the exception from the registration requirements for debt obligations for foreign-targeted debt. This change generally would eliminate deductions for interest paid with respect to such unregistered debt and subject interest payments on such debt to U.S. withholding tax.

There are varying effective dates for these foreign tax compliance provisions. While some provisions are proposed to take effect beginning in the first taxable year after the date of enactment, the withholding taxes imposed by the legislation would apply only to payments made after December 31, 2012.

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