Proskauer

Congress Moves Closer To Taxing Carried Interest as Ordinary Income

December 11, 2009

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%. The Extenders Act, if passed, would increase the federal tax on carried interest to a rate in excess of 37%, 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 previously 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.

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% penalty of the understated tax liability.
- Income attributable to ISPIs does not qualify for the exemption relied upon by many publicly traded investment partnerships to avoid corporate taxation (although a 10-year grace period applies for existing publicly traded firms).

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.

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. Under these provisions, a 30% U.S. withholding tax would be imposed on the gross income from U.S. financial assets 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 foreign entities with "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 the identity of all "substantial" U.S. owners.

In addition, the FATCA 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.

There are varying effective dates for the FATCA 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.

* * *

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code, or (iii) promoting, marketing, or recommending to another party any transaction or matter that is contained in this document.

Related Professionals

- **Arnold P. May**
  Partner
- **Amanda H. Nussbaum**
  Partner
- **Scott S. Jones**
  Partner
- **Charles (Chip) Parsons**
  Partner
- **Jamiel E. Poindexter**
  Partner
- **Marc A. Persily**
  Partner
- **Ira G. Bogner**
  Managing Partner
- **Bruce L. Lieb**
- **Stephen T. Mears**
  Partner
- **Mary B. Kuusisto**
  Partner
- **David W. Tegeler**
  Partner
- **David T. Jones**
  Partner
- **Howard J. Beber**
  Partner
- **Robin A. Painter**
  Partner
- **Christopher M. Wells**
  Partner