TAXATION OF CARRIED INTEREST OF FUND MANAGERS AT ORDINARY INCOME TAX RATES UNDER PROPOSED AMERICAN JOBS AND TAX CLOSING LOOPHOLES ACT OF 2010

Congress is currently considering H.R. 4213, the American Jobs and Closing Tax Loopholes Act of 2010 (the "Act"), which includes a provision that would apply ordinary income tax rates to carried profit interests from hedge funds, private equity funds, venture capital funds and other investment partnerships and would restrict the use of publicly traded investment management partnerships. Currently, investment managers entitled to preferential partnership allocations of investment fund profit (referred to as "carried interests") generally receive allocations that retain the character of a partnership's own income and realized gain, including that of long-term capital gain subject to a lower tax rate of 15%. The Act would treat taxable income and gain allocated from carried interests as ordinary income, currently subject to a maximum federal income tax rate of 35% for 2010 and 39.6% for 2011. For individuals, the portion of the profit recharacterized would be 50% for tax years beginning before January 1, 2013, and 75% thereafter. Under the Act, such ordinary income would also be included in income subject to self-employment tax.

Similar legislative proposals have been introduced previously. The Act is part of a bill that includes extension of certain tax cuts and other modifications of tax rules. The Act is expected to reach the floor of the U.S. House of Representatives shortly, and the Senate is also expected to consider the proposal soon after that. The new provisions would generally apply to tax years ending after the date of enactment of the Act.

Investment Services Partnership Interests. The Act would apply to "Investment Services Partnership Interests." An Investment Services Partnership Interest is defined as any partnership interest held directly or indirectly by any person if at the time such person acquired the interest it was "reasonably expected" that such person (or a related person) would provide, directly or indirectly, a "substantial quantity" of the following services with respect to assets held directly or indirectly by the partnership: (1) advising as to the advisability of investing in, purchasing or selling any securities, rental or investment real estate, interest in partnerships, commodities, or options or derivative contracts with respect to the foregoing, (2) managing, acquiring or disposing of any such specified asset, (3) arranging financing with respect to acquiring any such specified asset, or (4) any activities in support of any of the services described in (1), (2) or (3) (collectively, "Investment Services"). A change in services provided to a partnership may cause an interest that was not an Investment Services Partnership Interest to become such an interest.

Under the Act, the share of partnership items allocated to an Investment Services Partnership Interest (including capital gains and qualified dividend income) would be recharacterized as ordinary income or loss. Gain or loss on dispositions of such interests, except for an individual's disposition of interests in certain publicly traded partnerships, would also be treated as ordinary. Under the Act, gain on a disposition would be recognized notwithstanding any other income tax

provision providing for nonrecognition. Upon a partnership distribution of property with respect to an Investment Services Partnership Interest, the partner would also be taxed at ordinary income tax rates on any unrealized appreciation in the property. A net loss allocated to an Investment Services Partnership Interest and recharacterized as ordinary would be deductible only to the extent of previously allocated net income, less previously allocated net losses not disallowed, with excess loss amounts carried forward. A similar rule would apply to loss on a disposition of an Investment Services Partnership Interest, except that no loss carryforward provision would apply. An exception would exist for gain or loss recognition with respect to certain reorganizations or restructurings if an election were made to treat a partnership interest received in an exchange as an Investment Services Partnership Interest and certain reporting requirements were met.

An Investment Services Partnership Interest would also be characterized as an inventory item under section 751 of the Internal Revenue Code of 1986, as amended (the "Code"), which may result in ordinary income upon certain indirect dispositions of the interest, *e.g.*, sale of an interest in a partnership that owns an Investment Services Partnership Interest.

As mentioned above, for individuals, only 50% of net taxable income or loss allocated to, or gain or loss derived from the disposition of, an Investment Services Partnership Interest would be recharacterized as ordinary income or loss for tax years beginning before January 1, 2013, and only 75% would be so recharacterized thereafter. Under this rule, an amount recharacterized as ordinary would be allocated ratably among the partnership items of income, gain, loss and deductions. The special rules on gain recognition and loss limitations described above would only apply with respect to the nonexempted amount.

Qualified Capital Interests. The Act would provide an exception to ordinary income recharacterization for any portion of an Investment Services Partnership Interest considered to be a "Qualified Capital Interest." A Qualified Capital Interest is defined as the portion of a partner's interest that is attributable to (a) the fair market value of any money or property contributed to the partnership in exchange for such interest, plus (b) any amounts included in gross income as compensation under section 83 of the Code upon the transfer of such interest, plus (or minus) (c) any net income (or net loss) previously allocated to the interest, less (d) any distributions to the partner with respect to such interest. A Qualified Capital Interest would not include any interest acquired in connection with the proceeds of any loan or advance made or guaranteed directly or indirectly by any other partner or the partnership (or persons related thereto). If a non-Investment Service partner (or related person) makes or guarantees a loan to the partnership, a Qualified Capital Interest held by an Investment Service partner would also be adjusted to take into account such loan or guarantee.

Allocations with respect to a Qualified Capital Interest would qualify for the exception only if two requirements were met. First, the allocations would need to be made to such interest "in the same manner" as allocations to other Qualified Capital Interests held by unrelated non-Investment Service partners. The Act states that an interest would not fail this requirement merely because the partnership allocations to such interest do not reflect the costs of services

provided by the holder or a related person, *i.e.*, the absence of a charge for a carried interest or management fee would not prevent an interest from being a Qualified Capital Interest, except as otherwise provided by the U.S. Department of Treasury ("Treasury"). The Treasury would also be granted authority to provide guidance stating that the test would not be failed merely because an allocation to an Investment Service partner's Qualified Capital Interest represents a lower return than to other Qualified Capital Interests.

Second, to qualify for the exception the allocations to Qualified Capital Interests held by unrelated non-Investment Service partners must also be "significant" compared to the allocations made to the Investment Service partner's Qualified Capital Interest. The Treasury would be granted authority to provide regulations or other guidance to define when items of income, gain, loss and deduction would not be recharacterized as ordinary to the extent allocable to Qualified Capital Interests. The Act would allow the Treasury to provide guidance to apply the exception for Qualified Capital Interests separately with respect to a portion of a Qualified Capital Interest. Allocations that meet the requirements for Qualified Capital Interests in a lower-tier partnership would retain such character if allocated to Qualified Capital Interests in an upper-tier partnership.

Synthetic Equity Interests. Under the Act, ordinary income treatment would also apply to income or gain from certain synthetic equity interests held by investment managers in an investment fund or other entity (not necessarily a partnership). This recharacterization would apply if (1) a person performs directly or indirectly "investment management services" for an entity, defined as a "substantial quantity" of any Investment Services, (2) such person holds, directly or indirectly, a "disqualified interest" with respect to the entity, and (3) the value of such interest (or payments thereunder) is "substantially related" to the income or gain (whether or not realized) from the assets with respect to which the investment management services are performed. A "disqualified interest" would include (1) any interest in the entity other than indebtedness, (2) convertible or contingent debt of the entity, (3) an option or other right to acquire the interests described in (1) or (2), and (4) any derivative instrument entered into directly or indirectly with the entity or any investor in the entity. "Disqualified interests" would <u>not</u> include partnership interests and, except as provided by the Treasury, stock in an S corporation or any interest in a "taxable corporation," defined as a domestic corporation or a foreign corporation substantially all of the income of which is effectively connected with a trade or business in the United States or subject to a comprehensive foreign income tax. Exceptions similar to the Qualified Capital Interest exception described above and the exception for gain recognition on dispositions involving certain restructurings would also apply. The 50% exemption for individuals (25% for tax years beginning after December 31, 2012) described above would also apply with respect to this provision.

Penalties. The Act would apply a penalty of 40% to understatements attributable to the synthetic equity interests described above or violations of any future antiavoidance regulations promulgated by the Treasury. A reasonable cause exception would not apply unless (1) the relevant facts affecting the tax treatment of the item are adequately disclosed, (2) there is substantial authority for the treatment, and (3) the taxpayer reasonably believed that the tax treatment was more likely than not the proper treatment.

Self-Employment Taxes. The Act would also provide that an amount treated as ordinary income or loss under the above provisions is included in self-employment income subject to the self-employment tax on individuals if the recipient of the income or loss is engaged in the trade or business of providing Investment Services. To the extent an individual's gain or loss from a disposition of an Investment Services Partnership Interest would be recharacterized as ordinary income under the Act, an exception under present law for gain or loss from the sale or exchange of a capital asset would not apply.

Publicly Traded Investment Management Partnerships. The Act would also subject publicly traded investment management partnerships to the tax rules for corporations. A publicly traded partnership is entitled to flow-through treatment if 90% or more of its annual income is qualifying investment income. The Act states that such qualifying investment income would not include income recharacterized as ordinary income under the rules described above for an Investment Services Partnership Interest. However, certain partnerships owned 50% or more by real estate investment trusts ("REITs") and certain other partnerships holding primarily interests in publicly traded partnerships would be excepted from this rule. Furthermore, this provision would not take effect until ten years after the enactment of the Act.

Further Guidance Expected. The Act would provide authority to the Treasury to prescribe regulations or other guidance necessary or appropriate to carry out the purposes of the new provision, including guidance that would modify the application of the new provision (*e.g.*, treating persons as unrelated) to the extent consistent with the provision's purpose, prevent the avoidance of the new provision's purpose and coordinate the new provision with other provisions of the Code. A U.S. House and Senate Joint Committee on Taxation Report with respect to a prior version of the Act indicated that regulations are expected to address, among other items, U.S. or foreign source of income, whether income is considered effectively connected to a U.S. trade or business, including under certain U.S. real property investment rules, and application of the passive foreign investment company rules and rules on subpart F income for controlled foreign corporations. The Report indicated that the provision's intent is generally not to change the result under existing rules to the extent consistent with not providing an opportunity to avoid the recharacterization of income as ordinary under the provision and not creating an opportunity for exclusion or deferral of otherwise includable amounts. As an example, the Act is not intended to recharacterize amounts as foreign source income not subject to U.S. tax if such income would have been subject to U.S. tax under prior law, such as U.S. source dividend income or income effectively connected to a U.S. trade or business. The Report also indicated that it was not intended that the recharacterization of income as ordinary under the provision would cause income not otherwise treated as unrelated business taxable income ("UBTI") of a tax exempt organization to fail to meet section 512(b) exceptions to treatment as UBTI that are otherwise satisfied.

Effective Dates. The provisions of the Act would apply to dispositions and distributions with respect to an Investment Services Partnership Interest after the date of enactment. The provisions under the Act regarding a synthetic equity interest would take effect on the date of enactment. Except as otherwise indicated, the other provisions of the Act described above would apply to tax years ending after the date of enactment. For partnership taxable years that include

the effective date, there is a transition provision that waives certain estimated tax penalties and generally permits calculation of the ordinary income amount allocated to an Investment Services Partnership Interest on the basis of the lesser of the partnership's net income for the entire year or the portion of the tax year after the date of enactment.

The Act would also treat any transfer after the date of enactment of an interest in a partnership in connection with the provision of services to (or for the benefit of) such partnership as having a fair market value for compensation purposes under section 83 of the Code equal to the liquidation value of the interest (which for carried interests would generally be zero on the date of issuance). The provision would treat the person receiving the interest as electing to include such amount as compensation income in the year received under section 83(b) of the Code, unless such person elects otherwise.

The Act also contains other modifications to the Code, including those relating to the use of S corporations to avoid employment taxes, dispositions of spun-off companies, several provisions relating to cross-border issues and the extension of several credit, deduction and exemption provisions.

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