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Revised carried interest law could become effective soon

Many active participants in partnerships and limited liability companies (LLCs) may soon face significantly higher income tax burdens due to pending legislation that would require certain income to be taxed as ordinary income subject to self employment taxes. In the past this income could have been characterized as capital gains. The legislation is directed at investment services partnership interests (ISPIs), commonly known as "carried interests" or "profit interests," and is aimed at individuals who make their living in the real estate, venture capital, and/or private equity businesses.

On May 20, 2010, Senate Finance Committee Chairman Max Baucus (D-Mont.) and Acting House Ways and Means Committee Chairman Sander Levin (D-Mich.) jointly released proposed statutory language for the **American Jobs and Closing Tax Loopholes Act of 2010** ("the bill"), which includes changes to the taxation of ISPIs. The bill, which has strong support from the Obama administration, will likely be approved by the House before Memorial Day. However, the bill could face significant resistance in the Senate, so it is possible the law may change or could even be dropped from the legislation. Industries affected by the bill have been consistent in warning that it could have a significant negative impact on job growth, freeze transactions, cause further decline of asset values, and hinder business activity in neglected areas.

As drafted, the provisions impacting ISPIs will be effective for all taxable years ending after the bill is signed. Partnership income allocable to ISPIs subject to the new law in the year of enactment will be the lesser of either: (1) income for the year, or (2) income after the date of enactment. In addition, if you sell an interest in an ISPI after the date of enactment, the gain or loss on disposition would be subject to the new law.

Further, there is no distinction for partnership interests acquired before or after the date of enactment. Consequently, a transaction resulting in a long-term capital gain being recognized in 2010 before enactment would be subject to a federal tax rate of 15%. If it is recognized after enactment – either through allocable income or the sale of the interest in the ISPI – it could be subject to a federal rate of over 37.5 percent – more than 150 percent higher. **As a result, partners might want to recognize any built in long-term capital gains prior to enactment of this law.**

Possible federal rates applying to ISPIs

Although federal income tax rates could change in the future as a result of other legislation, below are the maximum income and Medicare tax rates that are currently scheduled to apply to long-term capital gains related to ISPIs before enactment and after enactment through 2013:

Before enactment	15.00%
After enactment to December 31, 2010	36.45%
2011 and 2012	31.25%
2013	37.55%

The bill treats 50 percent of income related to ISPIs as ordinary income starting from date of enactment to the end of 2012, and 75 percent as ordinary income starting in 2013. The maximum ordinary income and long-term capital gain rates are scheduled to increase in 2011 from 35 percent to 39.6 percent and from 15 percent to 20 percent, respectively. The ordinary income component will also be subject to Medicare taxes of 2.9 percent through 2012. After 2012, ordinary income will be subject to Medicare taxes at the rate of 3.8 percent and investment income (including capital gains), over a threshold, will also be subject to Medicare taxes at a 3.8 percent rate. The burden of Social Security taxes is not included in the percentages above.

Income related to ISPIs could come from (1) Income/gain allocated to the partner from the partnership, (2) The sale or other disposition of an ISPI, or (3) The distribution of appreciated property from the partnership.

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Investment services partnership and qualified capital interests

The bill creates Section 710 of the Internal Revenue Code. Section 710 defines an ISPI as any interest in a partnership held directly or indirectly by any person, if it was reasonably expected at the time the interest was acquired that such person (or any related person) would provide, directly or indirectly, a substantial quantity of any of the following services with respect to the assets held (directly or indirectly) by the partnership:

1. Advising on, investing in, purchasing, or selling any specified asset;
2. Managing, acquiring, or disposing of any specified asset;
3. Arranging financing with respect to acquiring specified assets; or
4. Any activity in support of any service described above.

However, a partner holding an ISPI can escape the higher tax rate on a qualified capital interest (QCI). Generally, a QCI is acquired upon the contribution of cash or property to the partnership in exchange for an interest that receives allocations of partnership items in the same manner as those made to partners not holding an ISPI. If the bill passes as currently written, guidance will be needed to clarify certain matters, including the situation where all partnership items are allocated to partners in the same manner and all partners provide services.

Penalties

The bill grants the IRS authority under IRC Section 6662 to double to 40 percent the penalties related to the understatement of tax attributable to avoidance of IRC Section 710.

Example

A partnership has a capital asset that could be sold for $20 million encumbered with debt of $18 million. The partnership's income tax basis in the asset is $10 million. Interests considered ISPIs own 20 percent and QCIs own 80 percent. Below are the results to the holders of the ISPIs if the asset is sold before or after enactment of the new bill:

	Before enactment	After enactment
Proceeds to ISPI partners	$ 400,000	$ 400,000
Federal income taxes	$ (300,000)	$ (529,000)
Net after tax proceeds/(cost)	**$ 100,000**	**$ (129,000)**

Conclusion

We will be monitoring the legislation as it moves through the late stages of discussion. We urge you to contact your Baker Tilly advisor with any questions and to discuss if there are any steps you should consider prior to enactment.

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