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Baucus and Levin Release Revised Carried Interest Legislation

On Thursday, May 20, 2010, Senate Finance Committee Chair Max Baucus (D-Mont.) and Acting House Ways and Means Committee Chair Sander M. Levin (D-Mich.) jointly released proposed statutory language for the *American Jobs and Closing Tax Loopholes Act of 2010* (the "Bill"), which includes proposed changes to the taxation of carried interest. House leaders have indicated that they intend to bring the legislation to vote early next week, although the legislative process beyond that is uncertain. It is possible that the proposed statutory language will continue to evolve or even that the provision will not be enacted as part of the Bill.

The proposed statutory language released last night is based on the carried interest provisions contained in the *Tax Extenders Act of 2009* (H.R. 4213), which passed the House of Representatives on December 9, 2009, but makes several important changes (the most significant of which is the blended rate discussed below). Another provision of the Bill would also make an important change for self-employment taxes of service-providing limited partners in management companies of investment funds that are organized as limited partnerships.

Carried Interest. As has been reported in the press, the Bill differs from prior proposals in that it provides for a "blended" rate of tax on carried interest and similar arrangements. For individual taxpayers, once it has been fully phased in by 2013, the Bill would treat 75% of carried interest as ordinary income and the remaining 25% as it is treated under current law (i.e., based on the underlying income of the fund in question). Until 2013, the percentages would be 50% and 50%. Gains from dispositions of carried interests would be subject to similar treatment and related rules would apply to distributions in kind to holders of carried interests. Amounts treated as ordinary income of service providers by reason of the Bill would also be subject to self-employment tax. As written, the Bill would cover both carried interests and so-called "fee waiver" or "MPI" interests. It would apply to a wide range of investment funds (including private equity, hedge, venture, real estate and oil and gas funds) and, as written, may also apply under certain circumstances to other types of partnerships, such as holding companies, that one would not generally consider to be funds. There are currently no carve-outs for special types of funds or industries.

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Effective Date. As drafted, the legislation would apply to all taxable years ending after the date the Bill is enacted into law. Another transition rule provides that, for the year of enactment, net income subject to the new rules is the lesser of the net income for the entire partnership year or the net income determined by taking into account only tax items attributable to the partnership year arising after the date of enactment.

Publicly-Traded Partnerships (PTPs).

- *Public "Shareholder."* The treatment described above would also apply to interests in publicly traded partnerships. A special rule appears intended to provide limited relief to gain on sale by investors who are not related to any person who provides services to the partnership, but a careful reading of the statutory language suggests that this relief may not apply to gain attributable to carried interest held through the PTP. It is not clear that this limitation was intended. As drafted, the relief does not apply to carried interest income flowing through the partnership to public holders.
- *Qualifying Income for Investment Manager PTPs.* As was the case in earlier versions of the legislation, income from an investment services partnership interest is not treated as "qualifying income" for purposes of the PTP passive income exception, which has the effect of causing publicly-traded investment managers to be treated as corporations. In an important change, however, the effectiveness of this rule is delayed for ten years for all partnerships, not just for PTPs in existence on the date of enactment.

Self-Employment Taxes for Limited Partners Providing Services. A second, unrelated, change may also affect investment professionals in the fund management area (and others). Under current law, many limited partners in management companies of investment funds do not pay self-employment taxes on income allocated to them from the management company. The proposed legislation would change this result and generally subject all income earned by principals who are limited partners in fund management companies to self-employment taxes. A more limited version of this change would also apply to S corporations.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. If you have questions regarding the foregoing, please contact:

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