

# Private Equity Alert

## New Proposal by the President on the Taxation of Carried Interest is Similar to Prior Congressional Proposals but Key Differences Exist

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On September 12, 2011, President Obama sent to Congress the legislative text of the American Jobs Act of 2011 (the "Jobs Act"). The Jobs Act would add, as a revenue raiser, new section 710 to the Code which would tax carried interest as ordinary income. New section 710 proposed by the Jobs Act is similar to the carried interest proposal passed by the House of Representatives in May 2010 but contains a few notable differences as discussed below. The broad reach of the prior proposal has been narrowed somewhat by proposed section 710, which defines an "investment partnership" as a partnership **substantially all** of the assets of which are specified investment assets. In addition, proposed section 710 recharacterizes **100%** (rather than 75% or 50% as in the prior proposal) of the carried interest income as ordinary income. The Jobs Act, if enacted as proposed, would become effective for tax years ending after December 31, 2012. Set forth below is a brief description of the more significant changes made by the Jobs Act compared to prior proposed legislation. For discussions of prior proposals, please see our prior Private Equity Alerts ([May 2010](#), [December 2009](#), [July 2009](#) and [July 2007](#)).

### Investment Services Partnership Interest

Pursuant to proposed section 710 of the Code, any net capital gain allocated with respect to an "investment services partnership interest" (an "ISPI") is taxed as ordinary income. The new definition of ISPI is tailored to target "carried interest" of investment funds. Under the Jobs Act, an interest in a partnership is an ISPI if (i) the partnership is an "investment partnership" (as discussed below) and (ii) such interest is acquired or held by any person in connection with such person's (or any person's related to such person) conduct of a trade or business that **primarily** (rather than substantially as in the prior proposal) involves the performance of investment management, finance, advisory or support services with respect to the assets of the investment partnership.

An investment partnership is any partnership if, at the end of any calendar quarter ending after December 31, 2012, (i) **substantially all** of its assets are "specified assets"<sup>1</sup> (other than section 197(d) intangibles but including cash and cash equivalents) and (ii) **more than 50%** of the contributed capital of the partnership consists of investment capital (i.e., capital attributable to contributions of property by one or more persons in exchange for interests in the partnership which, in the hands of such persons, constitute property held for the production of income.)

Under the prior proposal, there was a concern that section 710 might be applicable to an operating partnership or a pure management company that happened to hold only a minimal amount of specified investment assets. The Jobs Act clarifies that proposed section 710 will be applicable only with respect to an interest in an "investment partnership." Accordingly, it appears that an interest in an operating partnership or a

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management company less than substantially all of the assets of which are specified assets should not be subject to proposed section 710.

**Application of Ordinary Income Treatment**

The most recent prior proposal recharacterized only 75% of carried interest income as ordinary income (or 50% if such income was attributable to assets held for at least 5 years). In the case of gain on the disposition of an ISPI, the prior proposal would have treated 75% of such gain (or 50% if such ISPI was held for at least 5 years) as ordinary income. The Jobs Act, however, taxes 100% of carried interest income and any gain from the disposition of an ISPI as ordinary income.

**Capital Losses in Excess of Recharacterized Gains**

Prior proposals adopted a loss suspension rule pursuant to which losses in excess of the aggregate amount of previously recharacterized income were suspended and carried forward only to be used against future recharacterized income. The Jobs Act no longer contains a loss suspension rule and as such, any capital losses triggered in excess of the aggregate amount of previously recharacterized capital gains will be recognized currently as capital losses.

**Dividend Income**

The previous proposal provided that an individual partner that receives dividend income with respect to his or her ISPI could not qualify for the preferential dividend income tax rate, but was silent as

to whether a corporate partner could qualify for the dividends received deduction. The Jobs Act clarifies that dividend income allocated to a corporate partner with respect to its ISPI does not qualify for the dividends received deduction.

**Charitable Contribution of an ISPI**

Although gains arising from most transfers of ISPIs continue to be subject to ordinary income recharacterization and recognition under the Jobs Act, an ISPI that is disposed by gift or bequest to a charitable organization or to a person with respect to whom the transferred interest remains an ISPI does not trigger ordinary income recharacterization and recognition under proposed section 710 upon such transfers.

**Conclusion**

The President's proposal demonstrates the continued interest in Washington in changing the tax treatment of carried interest. Although the prospects for passage of a provision similar to proposed section 710 are uncertain, we will continue to monitor events and keep you updated as events unfold.

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<sup>1</sup> For this purpose, specified assets means securities (as defined in section 475(c)(2) without regard to the last sentence thereof), real estate held for rental or investment, interests in partnerships, commodities (as defined in section 475(e)(2)), cash or cash equivalents, or options or derivative contracts with respect to any of the foregoing.

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