CARRIED INTEREST TREATMENT AFFECTED BY PROPOSED LEGISLATION

Under a proposal jointly released last week by House and Senate tax writing committees, a portion of carried interest allocated to fund sponsors will be taxed at ordinary income rather than capital gains rates.

The proposal, called the American Jobs and Closing Tax Loopholes Act of 2010 (the "Jobs Act"), will apply to net income attributable to an "investment services partnership interest" – generally a profits interest issued by securities, real estate and venture capital funds in exchange for services (managing, acquiring or disposing of fund assets) reasonably expected to be provided to such funds.

For taxable years beginning before January 1, 2013, individual fund sponsors would be taxed on their carried interest not attributable to a return on invested capital as follows: 50% at ordinary income rates and 50% in the same manner provided by current law. For taxable years beginning on and after January 1, 2013, 75% of their carried interest would be taxed at ordinary income rates and 25% would be taxed as provided by current law. Carried interest received on invested capital would continue to be taxed at capital gains rates.

Under present law, fund sponsors are taxed on their carried interest at capital gains rates based upon the character of the underlying income items (i.e., qualified dividends and capital gains) generating the carried interest. The Jobs Act, by contrast, would tax at ordinary income rates a portion of an individual sponsor's carried interest (i.e., net income attributable to his investment services partnership interest).

If an individual sponsor sells his investment services partnership interest then a portion of the gain on the sale (50% for taxable years beginning before January 1, 2013 and 75% for subsequent taxable years) will be taxed at ordinary income rates. Any loss realized on the sale is also ordinary, but only to the extent of prior income inclusions for taxable years (or portions thereof) after the date of enactment of the Jobs Act. Sponsors also would owe self-employment taxes on the portion of their carried interest treated as ordinary income.

If the Jobs Act is enacted this year, it would apply to carried interest received during 2010 subject to a transition rule, under which the amount of 2010 carried interest subject to the new provision would be the lesser of the net income for the entire partnership taxable year or the net income determined by only taking into account the tax items attributable to the portion of the partnership taxable year after the date of enactment.

House leaders anticipate a vote on the Jobs Act as early as the week of May 24th. We will continue to monitor developments concerning this significant legislative proposal. Please feel free to contact Isaac Grossman (igrossman@morrisoncohen.com), Michael Weinstein (mweinstein@morrisoncohen.com) or Michael Kearney (mkearney@morrisoncohen.com) with any questions you may have.