

News from our Tax and Venture Capital groups

## House Considers Changes to Carried Interest Taxation and Foreign Account Reporting

On December 9, the House approved H.R. 4213 (“The Tax Extenders Act of 2009”), a bill which proposes to extend a package of 49 tax provisions otherwise slated to expire at the end of the year. Of particular note to venture capital, private equity and real estate funds, the bill also includes revenue raising provisions taxing “carried interest” at ordinary income rates and imposing a more robust regime for reporting and withholding with respect to foreign financial accounts and entities. Although the chances for inclusion of these two provisions in final legislation remain unclear, funds and their management groups should consider the proposed rules as part of their 2010 planning.

### Taxation of carried interest at ordinary income rates

The carried interest taxation rules in the bill are substantially the same as those found in H.R. 1935 previously proposed in the House. The bill proposes to impose ordinary income tax rates on profit allocations to investment fund managers (other than certain *pro rata* allocations attributable to invested capital), and would subject such profits to self-employment tax. A general partner’s carried interest allocations, as well as allocations in respect of management fee waiver and cashless contribution strategies, are among the types of profits that would be subject to the higher tax rate. Both realized income and gain, as well as unrealized gain on assets distributed in kind and transfers of partnership interests would be affected. The bill contains certain

anti-avoidance rules and significant penalties for violation of the anti-avoidance rules.

If the legislation is passed, these carried interest tax provisions would take effect for taxable years ending after December 31, 2009. Thus, for general partners and funds on a calendar tax year, the proposed carried interest tax rules would take effect on January 1, 2010. In its current form, the bill contains no grandfathering or transition provisions for existing carried interest arrangements.

### Reporting and withholding for foreign accounts and entities

The bill would impose a 30% withholding tax on payments of U.S. source income to foreign financial accounts owned by U.S. persons unless the financial institution maintaining such account enters into a special disclosure agreement with the U.S. Treasury Department concerning U.S. account holders. Similar rules in the bill also apply to payments of U.S. source income to certain foreign entities having U.S. owners. The bill also gives the Internal Revenue Service authority to require annual information reporting by U.S. shareholders of a passive foreign investment company (a so-called “PFIC”). Various effective dates would apply to the reporting and withholding provisions of the bill. Certain aspects would be effective for taxable years beginning after the date of enactment, while others would become effective two years after enactment.

### Further developments expected

Early indications suggest that the bill’s enactment will be postponed until 2010, and in any event the chances for passage of the carried interest and foreign reporting rules are unclear. If you have any questions about these developments, please contact your Cooley fund attorney or one of the attorneys listed below. ■

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