May 21, 2010

House lawmakers released legislation yesterday that again proposes to change the tax treatment of certain partnership and LLC "carried interests" for investment fund managers, including venture capital, private equity, hedge and real estate funds.

Taxation of carried interest at ordinary income rates

The American Jobs and Closing Tax Loopholes Act of 2010 proposes to impose ordinary income tax rates on a portion of the profit allocations to investment fund managers that are not attributable to invested capital. For 2010, ordinary tax rates would apply to 50% of either (i) the net carried interest allocations for the entire year or (ii) the net carried interest allocations for the portion of the year after the date the legislation is enacted, whichever is less. Ordinary tax rates would continue to apply to 50% of carry allocations for 2011 and 2012, and would apply to 75% of carry allocations starting in 2013. The bill would also subject the same percentages of carry allocations to self-employment tax. The remaining portion of profit allocations not attributable to invested capital, along with 100% of profit allocations attributable to invested capital, would remain eligible for taxation at capital gain tax rates (and would not be subject to self-employment taxes). 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.

Further deliberations

The carried interest language in this bill purportedly reflects compromise among House and Senate leadership. However, it remains unclear whether the carried interest provision ultimately will overcome opposition from various members of both parties in both the House and Senate, or whether further changes to the scope of the bill will be negotiated.

The House is currently expected to vote on the bill during the week of May 24. The timing for Senate consideration is unclear. We will issue additional Alerts as developments warrant. If you have any questions about these developments, please contact your Cooley fund attorney or one of the attorneys listed above.

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