

September 13, 2011

Obama Administration Submits Draft American Jobs Act to Congress that Would Tax Carried Interest Tax as Ordinary Income

Summary. On September 12, 2011, the Obama administration submitted statutory language for the proposed American Jobs Act to Congress. The Administration's proposal contains a number of revenue offsets, including an updated proposal to tax carried interest as ordinary income. The carried interest proposal is similar to and based on earlier versions of the proposed legislation that have passed the House of Representatives a number of times over the past several years, but have not passed the Senate. The Administration's proposal, however, makes some significant changes as compared to earlier versions.

In General. The legislation continues to recharacterize carried interest income and gain as ordinary income, and would apply to interests in traditional hedge funds, private equity funds, venture capital funds, and real estate funds that were the focus of the original legislation. It would also continue to treat gain on the sale of such interests as ordinary income.

Significant Changes.

- **Elimination of Blended Rate.** Net Capital Gain and dividend income from an Investment Services Partnership Interest or "ISPI" is recharacterized **entirely** as ordinary income. This is a change from some of the most recent legislative proposals, which used a blended capital gain/ordinary income rate that was lower than the full ordinary income rate.¹
- **Narrowed Focus – Limited to Investment Funds.** There was a concern that earlier versions of the legislation could have applied to interests in certain entities organized as partnerships other than investment funds (e.g., partnership holding companies, boutique investment banks, or other businesses organized as partnerships that are operating businesses). The proposed legislation introduces a concept of an "investment partnership" and a revised definition of "investment services partnership interest" (ISPI) that, while ambiguous in some respects, serve in many cases to narrow the application of the rule recharacterizing capital gain as ordinary income.
 - **ISPI Defined.** As revised, an ISPI is any interest in an investment partnership acquired or held by any person in connection with the conduct of a trade or business of managing certain specified assets owned by any person (or certain related parties). A trade or business qualifies for these purposes if it

¹ See our earlier client alerts describing the blended rate approach in prior versions of the proposed legislation, [here](#) and [here](#).

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primarily involves the performance of certain advisory or management services with respect to specified assets (as described below).

- “Investment Partnership” Defined. A partnership is an “investment partnership” for these purposes if both (A) substantially all of the assets of the partnership are specified assets (determined without regard to certain intangible assets, including goodwill), and (B) more than half of the contributed capital of the partnership is 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.

The specified asset definition has not changed significantly, and includes securities, real estate held for rental or investment, interests in partnerships, commodities, cash or cash equivalents, as well as options or derivative contracts with respect to those assets.

- Tax on “Enterprise Value” on Disposition. As a result of these changes, the treatment of gain on the sale of an interest in a partnership that serves as an investment manager but also owns a carried interest, fee waiver or other interest in the underlying investment funds it manages is not entirely clear and may depend on the specific facts of the particular transaction. We expect that these concepts may be further clarified during the legislative process in committee reports or otherwise. At a minimum, any gain attributable to fee waiver, carried interests or similar interests will be ordinary income. Note, however, that under the revised proposal, sales of interests in many operating businesses structured as passthroughs that might have been caught by prior versions of the legislative language will continue to be eligible for capital gains treatment, to the extent available under existing law.

Other Issues.

Many of the other relevant features of the proposal have been modified, but remain substantively similar to earlier versions.² For example:

- Ordinary income from an ISPI (including capital gain recharacterized as ordinary income) is subject to self-employment taxes;
- Gain and income in respect of certain qualified capital interests is excluded from being recharacterized as ordinary income; and
- Certain broad anti-abuse rules apply to other arrangements, including interests in certain corporations.

Effective Date. The proposed legislation would generally be effective for taxable years ending after December 31, 2012. For dispositions of interests, the legislation would apply only to dispositions after December 31, 2012 (which may mean that gain from the sale of an interest before December 31, 2012 with one or more deferred payments may not be subject to recharacterization).

² See generally our earlier client alert, [here](#).

Conclusion. In the current political climate, the outcome is unpredictable as it ever was, but the proposal certainly shows that the Administration's thinking on some of the underlying issues has evolved. As always, we will try to keep clients and friends informed about developments as the legislative process continues.

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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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