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Carried Interest Legislation Proposed

On May 20, 2010, the statutory language for the American Jobs and Closing Tax Loopholes Act of 2010 was released. That language includes revisions to current tax laws that would require many private investment fund managers and sponsors to pay tax at ordinary income rates on a portion of their "carried interests," as well as other controversial taxing and spending provisions. It is uncertain whether the Act will be passed in its current form, but Congressional action of some form is expected in the coming weeks.

Who is Affected?

The new legislation only applies to carried interests earned through an "investment services partnership interest" (an "ISP Interest"). An ISP Interest is any interest in a partnership which is held by any person if it was reasonably expected that such person would provide a substantial quantity of any of the following services with respect to assets held by the partnership:

- Advising as to the advisability of investing in, purchasing or selling any specified asset.
- Managing, acquiring, or disposing of any specified asset.
- Arranging financing with respect to acquiring specified assets.

- Engaging in any activity in support of any of the above-described services.

A specified asset includes certain securities, real estate, interests in partnerships, commodities, and derivatives or options on the foregoing.

Examples of ISP Interests may include a general partner's "carried interest" or "promote" in typical private equity, real estate and hedge fund structures, as well as other incentive allocations found in various other forms of investment partnerships, such as "LTIPs" issued by certain operating partnership subsidiaries of real estate investment trusts.

While some industry commentators expected the legislation to exclude venture capital funds and real estate funds, the proposed definition does not offer any such exclusions. A small carve-out is made for certain partnership interests owned by real estate investment trusts. That carve-out does not apply to LTIPs.

Special Rule for Individuals

The new legislation generally taxes 100% of carried interest earnings as ordinary income, but taxes only 75% of carried interest earnings as ordinary income when earned by individuals (50% for tax years beginning before 2013). The remaining amount is taxed according to its character under existing law. Fund

principals and employees that currently hold an interest in their fund through trusts or other holding companies may want to consider restructuring their ownership of such interests.

Qualified Capital Interests

In most investment funds, the general partner invests capital in the fund alongside the limited partners. Thus, a portion of the general partner's return is a carried interest and a portion is a return on the general partner's invested capital. The new legislation recognizes a distinct capital investment and does not convert income allocations on "qualified capital interests" to ordinary income.

To avoid converting income allocations to ordinary income, such allocations to qualified capital interests held by persons that also hold ISP Interests must be on similar, but not necessarily identical, terms to allocations for qualified capital interests offered to a significant number of non-service providers. For example, a qualified capital interest need not be charged with the economic cost of management fees or carried interest, which are common features of partnership capital interests held by fund principals and employees.

In addition, there are specific rules regarding how a qualified capital interest can be funded, which essentially

prohibit the investor partners from being a funding source for a service partner's investment. Thus, the LP loan model that some industry participants surmised might be a solution to earlier versions of proposed carried interest legislation would not appear to achieve the desired result under the currently proposed legislation.

Transfers of ISP Interests

The proposed legislation also provides that sales and other transfers of an ISP Interest would generally be taxable at ordinary income rates even if such a transfer would typically be tax-free under current law. However, the new legislation does carve out certain contributions to and distributions from partnerships, including certain partnership mergers and divisions, provided the relevant parties elect to treat their newly acquired interest as an ISP Interest and to comply with certain reporting requirements.

Penalties for Non-compliance

The proposed legislation also includes efforts to deter attempts to circumvent the new requirements. Penalties for non-compliance with these proposed provisions would be 40% of any understatement, as opposed to 20% under current law. Further, the "reasonable cause" defense to the penalty would only be available where

the taxpayer's tax return included relevant disclosures, there was or is "substantial authority" for the position, and the taxpayer reasonably believed that the position was more likely than not the proper tax treatment.

Effective Date

The proposed legislation is effective for tax years ending after the date of enactment. Based on the current version, parties that desire to effect liquidations or reorganizations in light of the new legislation may need to complete those transactions prior to the date of the enactment. For tax years including the date of enactment, the amount of income subject to the new legislation is equal to the lesser of the net income for the entire tax year or the amount of income attributable to the period after the date of enactment.

The tax lawyers at Hunton & Williams LLP can help you determine the impact of the proposed legislation on your business and are working with lawyers in the Private Investment Funds and Real Estate Capital Markets groups to assist clients with planning for any restructuring that may be necessary or desirable. If you would like to receive more information about the new legislation, please contact any of the lawyers listed on this alert. Read the [legislation](#).

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