

Legal Update

Anti-Carried Interest Legislation May Be Enacted Soon

May 2010

The American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213) (the “Legislation”) would add Section 710 to the Internal Revenue Code. Section 710 would significantly change the tax treatment of carried interest holders, including hedge fund managers. (The Legislation would also subject certain limited partnership and S corporation income to self-employment tax.)

There had been some expectation that Congress would vote on (and approve) the Legislation prior to Memorial Day. Although it appears that Section 710 will soon be enacted, the Legislation has not been passed and is subject to change

Some Key Features of the Legislation Affecting Carried Interests

- Recharacterizes carried interest income as ordinary income. This potentially increases the tax rate applicable to such income from 15% to 35% (at 2010 rates). However, individuals retain flow-through treatment for 50% (25% after 2012) of carried interest income, and thus a carried interest may still provide a tax rate benefit (as compared to a fee).
- Recharacterizes gain on sale of a carried interest as ordinary income. However, individuals continue to qualify for capital gain treatment as to 50% (25% after 2012) of such gain.
- Permits flow-through treatment for allocations with respect to a manager’s “qualified capital”,

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notwithstanding the general recharacterization rule. Qualified capital generally includes the manager's invested capital and prior allocations of income, as reduced by distributions and prior allocations of losses. There are complex limitations to this exception. For example, qualified capital does not include capital borrowed from the fund, investors or "related persons".

- Imposes self-employment taxes on recharacterized carried interest income.
- Imposes broad and severe anti-avoidance rules. Section 710's general recharacterization rule is extended to non-partnership vehicles, such as foreign corporations, derivatives, and options, and violations of these rules are subject to a 40% penalty. Treasury is also granted broad rulemaking authority to enforce Section 710, and violations of Treasury's anti-avoidance regulations are subject to a 40% penalty.
- The Legislation is generally prospective. The general recharacterization rule applies to 2010, though it is limited to post-enactment taxable income. There is no grandfathering of existing carried interest or other arrangements.

Generally Not Affected by the Legislation

- Timing of taxation of carried interest income. Managers generally should be able to defer taxation to the extent that a carried interest represents income on unrealized positions. However, transfers of carried interests are generally subject to tax, even if they would otherwise (in the absence of Section 710) be tax-free.
- The "non-compensatory" character of carried interest income. Sections 409A and 457A (which provide restrictions and/or penalties on deferred compensation) generally should continue to not apply to carried interests.
- Investors. The carried interest continues to be respected as an allocation, and thus investors are not subject to miscellaneous itemized deduction limitations with respect to carried interest allocations (as they may be with respect to fees). This is of particular importance to funds that are not (or may not be) "traders".

Many Questions Remain

- There are many uncertainties as to interpretation and application. These include difficulties in applying the "qualified capital" rules. An additional issue raised under the Legislation's most recent draft is whether an individual participating in a carried interest through another entity, such as a partnership or S corporation, would qualify for the 50% (25% after 2012) flow-through of carried interest income. There would not appear to be a policy justification for such a limitation.

- There may be state and local tax implications. These would depend on the manager's location. For example, the interaction of Section 710 with the New York City unincorporated business tax is not entirely clear.
- Regulations may make significant revisions and clarifications. Section 710 includes a broad grant of rulemaking authority to Treasury, and substantial interpretive guidance is probably necessary and inevitable. Because the anti-avoidance regulations are directed to "carry out the purpose of" Section 710, however, the legislative history (which presently does not exist) may be of great importance.
- The Legislation may still be revised. Section 710 has been subject to numerous revisions during the drafting process, and may be subject to further revisions prior to enactment.

What to Do Now

Despite Section 710, a carried interest will still often be the most tax-efficient structure for hedge fund manager and other asset manager performance-based awards. However, if the Legislation is enacted, existing carried interest structures should be reviewed to understand how they are affected by Section 710, and whether they may be improved through restructuring or otherwise. Also, Section 710 should be taken into account if you are considering selling some or all of your interest in an entity that receives a carried interest.

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