

NEW PROPOSAL TO TAX CARRIED INTEREST AS ORDINARY INCOME

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To Our Clients and Friends:

As you may have read, on September 12, President Obama released the text of the proposed American Jobs Act of 2011, which includes provisions that would tax carried interest as ordinary income. The proposed carried interest provisions generally would become effective on January 1, 2013. The Jobs Act's carried interest provisions are based largely on prior Congressional proposals to tax carried interest as ordinary income and would fix a number of technical issues with the prior proposals (other issues remain unresolved). However, there are several significant differences:

Taxation of carried interest. The bill would tax at ordinary income rates 100% of net capital gains and "qualified dividend income" attributable to an "investment services partnership interest" (*i.e.*, the carried interest). Previous proposals generally would have treated only 75% of the carried interest as ordinary income and would have taxed the remainder based on the nature of the underlying income of the partnership, thereby preserving the favorable treatment of carried interest under current law for 25% of the carried interest.

Taxation of enterprise value. 100% of any gain from the sale of an "investment services partnership interest" would be treated as ordinary income. This provision is particularly controversial because it would subject individuals to a higher rate of taxation on gain from the sale of a carried interest partnership than on gain from the sale of other businesses. A prior proposal generally would have taxed only 75% of such gain (50% in the case of a five-year holding period) at ordinary income rates.

Narrower definition of carried interest. The bill limits the scope of the new carried interest regime by narrowing the definition of "investment services partnership interest." Previous proposals potentially applied to partnerships that held (directly or indirectly) any "specified assets" (including securities, real estate, interests in other partnerships, commodities, or options or derivative contracts with respect to the foregoing), without regard to the materiality of these assets to the partnership. In contrast, the bill would only apply to an "investment partnership" acquired or held in connection with the conduct of trade or business that involves providing certain services with respect to specified assets held

by the partnership. A partnership would be treated as an investment partnership if, at the end of any calendar quarter ending after December 31, 2012, substantially all of the partnership's assets (other than goodwill and other intangible assets) consist of specified assets and more than 50% of the contributed capital of the partnership is attributable to persons that hold their interests in the partnership for the production of income. Limiting the application of the carried interest rules to investment partnerships may help protect, for example, the sale of management companies that hold specified assets from inadvertent taxation under the enterprise value regime.

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