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Carried Interest Tax Legislation Alert

Re-characterizes Certain Capital Gain Tax Allocations to a Partner of a Partnership or a Member of a Limited Liability Company as Ordinary Income

Background

Partnership structures under subchapter K (which usually include limited liability companies because they are generally taxed as partnerships) have historically provided a flexible vehicle that parties could use to establish complex economic arrangements. Often, as part of the economic arrangement, the capital partners of a real estate, venture capital or private equity partnership would incent the developer, manager, sponsor or other service partner to go the extra mile with a percentage interest in back-end profits of the partnership. Often this incentive is called a "profit interest" or "carried interest."

While the US House of Representatives in the past has approved legislation that would have adversely affected such carried interests, the US Senate showed little interest in enacting similar carried interest legislation. The House last passed legislation that would have adversely affected carried interests as part of this past December's Tax Extenders Act of 2009 (H.R. 4213), which mainly would have extended certain tax-favorable provisions that have expired or are expiring.

The Senate failed to include any carried interest

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provision in the Senate version of the House bill it passed this past March. However, we understand that the Senate is now committed to passing some sort of carried interest legislation to pay for the remainder of the legislation contained in the Tax Extenders Act of 2009 (H.R. 4213), and it now seems likely that the Senate will pass some version of the carried interest provision passed last December by the House by Memorial Day. The ultimate scope of new Section 710 will depend on the results of negotiations among congressional representatives and the administration.

Proposed new Section 710 of the Tax Extenders Act of 2009 (H.R. 4213) generally denies capital gains tax rates to the holder of an "investment services partnership interest" within the meaning of proposed Section 710(c) unless such interest does not differ in terms from interests held by non-service providers or mere investors.

An interest is an "investment services partnership interest" under proposed Section 710(c) if it was reasonably expected (at the time the partner acquired such interest) that such person (or any person related to such person) would provide (directly or indirectly) a substantial quantity of any of the following services: (i) advising the partnership with respect to investing in, purchasing or selling a specified asset (i.e., securities, real estate held for rental or investment, partnership interests, commodities, or options or derivatives contracts with respect to these assets); (ii) managing, acquiring or disposing of any specified asset; (iii) arranging financing with respect to acquiring a specified asset; or (iv) any activity in support of any of the previously described activities.

Some of the Problems With the Currently Proposed Section 710

1. **Applies Retroactively.** As currently drafted, Section 710 generally would be effective for tax years ending after December 31, 2009.
2. **Overly Broad.** Unfortunately, this legislation has a number of problems. First, all partners of a partnership comprising only capital partners may be allocated tax allocations that are required to be re-characterized as ordinary income if there are not any unrelated partners. Second, typical subordination on liquidation or other risk of loss arrangements among capital partners could cause certain partners to be allocated tax allocations that are required to be re-characterized as ordinary income. This would be true even if such

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partners do not provide management services.

3. **Dispositions of Carried Interests.** Any gain from a disposition of an "investment services partnership interest" would be ordinary income, including transactions that ordinarily would result in tax deferral such as partnership roll-ups or contributions of an interest to another partnership.
4. **Distributions of Appreciated Property to Holders of an Investment Services Partnership Interest.** Any distribution of property to a partner holding an "investment services partnership interest" would result in: (i) the gain (i.e., difference between the value of the property and its tax basis) being recognized by the partnership; (ii) such gain being characterized as ordinary gain; and (iii) all such ordinary gain being allocated to the partner holding an investment services partnership interest. In addition, the property distribution to the partner would be treated as a cash distribution in an amount equal to the value of the property, which could result in further gain to the partner if the deemed cash distribution is in excess of his tax basis of his partnership interest.
5. **Losses Allocated to Holder of an Investment Services Partnership Interest.** Losses allocated to a holder of an investment services partnership interest would be deferred until income is allocated to such partner or the interest is sold or liquidated, which could result in such losses being re-characterized as capital losses.
6. **Ordinary Income Allocated to Holder of an Investment Services Partnership Interest.** To the extent income is re-allocated as ordinary income, such income would be subject to self-employment tax even if the underlying income (e.g., capital gains) was exempt from self-employment tax.

Conclusion

We will continue to follow this legislation closely. In light of the substantial probability that some version of the carried interest legislation will be enacted, parties should consider adding appropriate language to their agreements governing the partnership or limited liability company to provide sufficient flexibility to restructure their arrangements so as to minimize the impact of any carried interest legislation. We will be happy to assist you in drafting such provisions. If you need assistance

or have any questions regarding this pending legislation, please feel free to call either your principal contact at Squire Sanders or any of the persons who are listed on this Alert.

The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations. Counsel should be consulted for legal planning and advice.

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