VENABLE LLP

tax bulletin

www.Venable.com
JUNE 2010

Authors

Charles Kolstad
ckolstad@Venable.com
310.229.9954

Robin Gilden
rcgilden@Venable.com
310.229.9967

Brian O'Connor
bjoconnor@Venable.com
410.244.7863

If you have any questions regarding this bulletin, please contact any member of our **Tax and Wealth Planning** practice group.

Proposed Carried Interest Legislation: Traps for the Unwary

The House of Representatives, the Senate, and the White House have been considering proposed legislation affecting the tax treatment of partnership profits interests issued to service providers (so-called "carried interests") since 2007. After years of debate, the House finally stepped forward on May 28, 2010 and passed the **American Jobs and Closing Tax Loopholes Act of 2010**, which contains tax law changes affecting carried interests in new section 710 of the Internal Revenue Code. Because the Senate will now consider the Act and additional amendments are expected, the final language of this legislation remains uncertain. But, many believe that carried interest legislation will be enacted in one form or another in 2010.

There are a number of traps for the unwary contained in the Act that may require action sooner rather than later.

Trap #1 – The Act applies to all carried interests, regardless of when issued.

The Act applies to all carried interests which constitute investment services partnership interests ("ISPIs") under the new tax rules, including those issued before the effective date of the Act. All present holders of carried interests need to be aware of the new tax law and its effect on the economics of their carried interest arrangements.

Generally, the new rules for carried interests are effective for taxable years ending after December 31, 2010. For most individual taxpayers, this will mean that gains on ISPIs will be recharacterized as part capital gain and part ordinary income for sales after December 31, 2010. Holders of historical carried interests that will become ISPIs should consider taking action before December 31, 2010 to trigger any unrecognized gain so that such gain may qualify for the current lower capital gains rates (15%), rather than the new higher blended rates in the House version of the Act (29.8% in 2011 and 2012 and 34.7% after 2012).

Trap #2 – Once an ISPI, ISPI taint may stick.

A sale of a carried interest that constitutes an ISPI to a related purchaser for value does not purge the ISPI of its partial ordinary taint. Accordingly, a related purchaser of an ISPI will be subject to the new tax rules even if the purchaser provides no services to the partnership. This will make carried interests particularly unattractive to related purchasers, and thus may increase the applicable discount from fair market value calculated in reaching an appropriate purchase price. The better reading of the current statutory language is that unrelated purchasers will not assume the partial ordinary taint when they acquire ISPIs. In light of some confusion on this issue, we would welcome stronger language from the Senate clarifying this point.

Trap #3 – Can using a holding company convert a non-ISPI into an ISPI?

Only certain partnership interests constitute ISPIs - those issued to certain service providers by partnerships investing in "specified assets" such as securities (a very broadly defined term), real estate held for rental or investments (not including real estate used in an active business, such as a hotel or restaurant) or partnership interests. The good news here is that service providers holding interests in partnerships with operating businesses unrelated to investments or real estate are likely to escape the effects of the new rules. However, because the new legislation includes "partnership interests" within the definition of "specified assets," service providers holding interests in operating partnership subsidiaries indirectly through holding company partnerships may be captured by the new rules even though those same service providers would avoid the rules entirely by holding interests in the operating company subsidiaries directly. Based on the current statutory language, the mere use of a holding company to hold partnership interests that do not qualify as ISPIs may cause a holding company carried interest to become an ISPI.

To avoid this holding company trap, partners holding interests in holding company partnerships that may become ISPIs should consider redeeming those interests with direct interests in the operating partnership subsidiaries. To avoid adverse tax consequences on the redemptions, however, they must take place as soon as possible or before the end of the year. For partners unable to effect redemptions of their interests in time, there certainly is the prospect of regulations ultimately clarifying this issue in a taxpayer-favorable manner. Such regulations, however, may take years for the Treasury to issue.

Trap #4 – You cannot avoid the carried interest rules through partnership related loans.

The new carried interest rules do not apply to the extent that an ISPI constitutes a qualified capital interest (“QCI”). Accordingly, many holders of carried interests will seek to restructure the terms of their carried interests so that their interests constitute QCIs. This could be done, among other ways, by contributing capital to the partnership in exchange for an interest. Under the Act, however, an ISPI acquired with the proceeds of a loan from the partnership, or partners in the partnership, will not qualify as a QCI. Accordingly, other more creative means of creating QCIs will need to be explored.

Trap #5 – Distributions of appreciated property create taxable income.

In general, distributions of appreciated property by partnerships to partners do not result in taxable gain or loss for either the distributing partnerships or the distributee partners. Instead, the tax basis of the distributed property merely carries over to the distributee partners.

Under the Act, if a partnership distributes appreciated property to a holder of an ISPI, the partnership recognizes gain equal to the excess of the fair market value of the property over its tax basis. This gain, moreover, is generally allocated to the holder of the ISPI. Then, to make matters even worse for the ISPI holder, the value of the distributed property is treated as a cash distribution to the ISPI holder that may produce even more taxable income for the ISPI holder. Accordingly, to the extent that any partnership is considering making any property distributions to future holders of ISPIs, those distributions should be accelerated to avoid the adverse tax consequences associated with the Act.

Trap #6 – The provisions of the Act apply separately to each ISPI.

One of the effects of the new legislation is to limit the use of losses incurred with respect to the ordinary portion of a particular ISPI to the income produced by that same ISPI, without regard to whether such losses would otherwise be deductible under the passive loss rules or the at risk rules. This ultimately has the effect of accelerating tax on other income to the extent that allocable ISPI losses would have otherwise been available to offset such income.

Trap #7 – Non-recognition provisions do not always apply.

The new tax rules provide that any gain realized on the disposition of the ordinary income portion of an ISPI generally will be recognized and taxed as ordinary income. Surprisingly, this provision generally overrides otherwise applicable non-recognition provisions, except for transfers of ISPIs to partnerships where the transferring partners elect to treat the interests received as ISPIs and agree to comply with applicable reporting and recordkeeping requirements. This means that, as a result of the legislation, transfers of ISPIs to corporations (including REITs) will become taxable events, even when those transfers would otherwise fully satisfy longstanding tax-free requirements.

Trap #8 – 40% underpayment penalty.

Congress recognized that taxpayers may seek to structure carried interests to avoid having them classified as ISPIs and thus subject to the new rules. Under the Act, a 40% penalty applies to underpayments of income attributable to a recharacterization of a carried interest as an ISPI. Taxpayers can avoid this penalty only if (i) they disclose the transaction on their tax returns, (ii) there is substantial authority for their treatment and (iii) they reasonably believe that their treatment was more likely than not to be correct.

The new carried interest legislation contains a number of surprising traps for the unwary. In light of these unwelcome traps, holders of carried interests should quickly review their interests to determine whether they would constitute ISPIs under the Act, and if so, whether they can take any action before the end of 2010 to avoid the new tax rules. In particular, holders of holding company carried interests should revisit their arrangements quickly, as should any potential future recipients of partnership property distributions. Finally, in negotiating new carried interest arrangements, service providers should consider including clauses in their partnership and LLC agreements allowing for future restructuring to avoid traps currently hidden in the new legislation that will inevitably emerge over time.

If you have any questions regarding this bulletin, please contact any member of our **Tax and Wealth Planning** practice group.

If you have friends or colleagues who would find this newsletter useful, please invite them to subscribe at www.Venable.com/subscriptioncenter.

CALIFORNIA MARYLAND NEW YORK VIRGINIA WASHINGTON, DC

1.888.VENABLE | www.Venable.com

©2010 Venable LLP. This alert is published by the law firm Venable LLP. It is not intended to provide legal advice or opinion. Such advice may only be given when related to specific fact situations that Venable has accepted an engagement as counsel to address.

U.S. Treasury Circular 230 Notice: Any tax advice contained in this bulletin (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (a) avoiding penalties that may be imposed under the Internal Revenue Code or by any other applicable tax authority; or (b) promoting, marketing or recommending to another party any tax-related matter addressed herein.

Click here to unsubscribe

***

575 7th Street, NW, Washington, DC 20004

© 2010 Venable LLP | www.Venable.com | 1.888.VENABLE