

## POTENTIAL CHANGES TO TAXATION OF CARRIED INTEREST

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On May 28, 2010, the U.S. House of Representatives passed the American Jobs and Closing Tax Loopholes Act of 2010 (Act). The Act, if passed by the Senate, would add a new Section 710 to the Internal Revenue Code (Code) that addresses certain tax consequences stemming from the receipt and ownership of a partnership interest by a provider of services to the partnership. In short, the commonly used "carried interest" would lose its favorable capital gains treatment and instead be treated and taxed as ordinary income.

Section 710 would generally treat a service-provider partner's distributive share of net income from an "investment services partnership interest" (ISPI) as ordinary income, except to the extent it is attributable to the partner's "qualified capital interest." An ISPI is a partnership interest held directly or indirectly by any person if it was reasonably expected that the person (or any related person) would provide or has already provided, directly or indirectly, a substantial quantity of management and advisory services with respect to assets held by the partnership. The services described by the provision include:

- advising on investing in, purchasing or selling any securities, real estate held for rental or investment, interests in partnerships, commodities, or options or derivative contracts with respect to such securities, real estate, partnership interests or commodities
- managing, acquiring or disposing of any specified asset
- arranging financing with respect to acquiring specified assets
- any activity in support of any of the foregoing services.

The provision contains an important exception to recharacterization as "ordinary income" of items of income, gain, loss and deduction that are allocated to the portion of an ISPI that is a "qualified capital interest". A qualified capital interest is the amount of a partner's interest in partnership capital attributable to:

- the fair market value of money or other property contributed by the partner to the partnership in exchange for the partnership interest
- the amount included in the partner's gross income as compensation under Section 83 of the Code with respect to the transfer of the partnership interest by the partnership for services
- the partner's distributive share of cumulative net income and gain of the partnership included in the partner's income that has not been distributed by the partnership.

New Section 710 contains a variety of other rules that are designed to challenge any planning to avoid recharacterization. Additionally, Section 710 prescribes rules for the treatment of losses, dispositions and partnership distributions. A net loss with respect to an ISPI is treated as an ordinary loss, but is only allowed under certain qualifying circumstances. On the disposition of an ISPI, gain is treated as ordinary income, notwithstanding the general rule that gain or loss from the disposition of a partnership interest is considered capital gain or loss. And, in the case of a distribution of property by a partnership to a partner with respect to an ISPI, the partner recognizes ordinary income to the extent of any built-in gain in the property.

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Section 710 is effective for taxable years ending after December 31, 2010, so calendar year partnerships may have the possibility of restructuring during 2010 to ensure that some or all of a service-providing partner's partnership interest will be a qualified capital interest.

The Act still must be considered and approved by the U.S. Senate. Until recently, the House of Congress has been reluctant to embrace taxing "carried interest" as ordinary income, but rising deficits may outweigh their concerns.

Please contact any of the attorneys listed below if you have any questions regarding new Section 710 or any other provision of the Act.

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