

Taxation of Carried Interest as Ordinary Income

PENpoints

The recently unveiled carried interest bill will, if enacted, tax a portion of carried interest net income earned from an investment partnership or LLC as compensation income subject to ordinary income tax and uncapped Medicare tax.

Revised Carried Interest Proposal

On May 20, 2010, the Chairmen of the Senate Finance Committee and the House Ways and Means Committee unveiled their long-expected carried interest bill¹ that (if enacted) would tax a portion—50% in 2010 through 2012 and 75% after 2012—of carried interest net income earned from an investment partnership or LLC as compensation income subject to (1) ordinary income tax and (2) uncapped Medicare tax (regardless of the nature of the partnership/LLC's underlying income).

This carried interest proposal would generally be effective immediately upon enactment, regardless of when the investment partnership/LLC was formed or when the partnership/LLC made the underlying investment. For 2010, however, the proposal would apply **only** to 50% of carried interest net income recognized (e.g., attributable to asset sales and dividends received) **after** the day the president signs the bill **or**, if less, 50% of carried interest net income for all of 2010. In addition, for 2010, the bill's provision treating as ordinary compensation income 50% of (x) appreciation in an asset distributed in kind to a carried interest holder and (y) gain on sale of a carried interest would apply **only** if such in kind distribution or sale gain occurs after day of enactment. Accordingly, the proposed new rules would **not** apply to appreciated property distributed in kind or sale gain occurring **on or before** the day the president signs the bill (possibly as soon as the week of May 31, 2010, if both houses of Congress pass the bill without delay).

For tax years subsequent to 2010, 50% of an investment professional's carried interest net income would be treated as ordinary compensation income, increasing to 75% for tax years beginning on or after January 1, 2013. The portion of net income attributable to carried interest not treated as ordinary compensation income under this proposal (50% through 2012 and 25% thereafter) would continue to be treated as a dis-

tributive share of the underlying partnership's income (e.g., capital gain, interest or dividend income).

For carried interest income that otherwise would have been taxable as long term capital gain, this bill would produce an effective federal rate of:

- 25% for 2010 (as compared to the 15% capital gain rate and 35% ordinary income rate);
- 29.8% for 2011 and 2012 (as compared to the 20% capital gain rate and 39.6% ordinary income rate scheduled to be in effect); and
- 34.7% for 2013 and later years (when 75% of such carried interest income would be taxed as ordinary income) plus the 3.8% Medicare tax effective in 2013 under the recently enacted healthcare legislation discussed in a prior [KirklandPEN](#) (resulting in a total 38.5% rate).

Similar to prior unenacted House bills, this proposal:

- would apply only to investment professionals earning carried interest from an investment partnership/LLC, including a private equity, venture capital, hedge fund or real estate investment partnership/LLC;
- would treat as ordinary compensation income, gain on sale of a carried interest and appreciation in an asset distributed in kind to a carried interest holder, and would treat carried interest losses as ordinary losses (up to the amount previously taxed as carried interest ordinary income under this provision); and
- would not apply to allocations to a "capital interest" in a partnership/LLC, even if the capital inter-

INSIDE KIRKLANDPEN

Upcoming Events 3

est is held by a service provider, so long as the capital interest generally receives the same proportionate allocation of income and gain as capital interests held by non-service partners, but such a capital interest would not include a partnership/LLC interest purchased with the proceeds of a loan or other advance made or guaranteed, directly or indirectly, by the partnership/LLC or by a partner not providing services to the partnership/LLC.

In addition, the bill contains a provision previously passed by the House (and discussed in an earlier *KirklandPEN*) intended to tax as a corporation (rather than as a flowthrough entity) any publicly traded partnership/LLC (a “PTP”) deriving significant income from investment advisory or asset management services.

New Proposal to Subject Flow-Through Service Income to Social Security and Medicare Tax

The bill also contains a provision treating a service provider’s distributive share of income earned through an S corporation or partnership/LLC as self employment income subject to the uncapped 2.9% (3.8% beginning 2013) Medicare tax.²

Although current law already treats salary and bonus paid by an S corporation or partnership/LLC as subject to such tax, under current law earnings passed through to shareholders from an S corporation, a limited partner’s distributive share of partnership income, and possibly an LLC member’s distributive share of LLC income are generally not treated as “net earnings from self employment,” and therefore not subject to Medicare tax, even if the income is earned in connection with the performance of services (e.g., income allocated to partners in a management company providing investment advice).

Under the bill, an S corporation shareholder or a partner in a partnership/LLC engaged in a “professional service business” must generally treat income earned through the S corporation or partnership/LLC as self employment income if the shareholder or partner provides substantial services with respect to the business. For this purpose, a “professional service business” includes any business providing services of the following types: investment advice or management, health, law, lobbying, consulting, engineering, architecture, accounting, actuarial science or brokerage services. This provision would be effective for tax years beginning after December 31, 2010.

¹ H.R. 4213, The American Jobs and Closing Tax Loopholes Act of 2010.

² As noted in a prior *KirklandPEN*, beginning January 1, 2013, an additional 0.9% Medicare tax is imposed on an individual’s wages and self employment income in excess of \$250,000 for a joint return (or \$200,000 for most other types of returns).

If you have any questions about the matters addressed in this *KirklandPEN*, please contact the following Kirkland authors or your regular Kirkland contact.

Jack S. Levin, P.C.

<http://www.kirkland.com/jlevin>

+1 312-862-2004

Donald E. Rocap

<http://www.kirkland.com/drocap>

+1 312-862-2266

Paul D. Patrow

<http://www.kirkland.com/ppatrow>

+1 312-862-2219

PENnotes

ACG Chicago's "Is Venture Capital a Valid Asset Class?"**Chicago, Illinois****May 24, 2010**

This program, hosted by the Association for Corporate Growth, will focus on the validity of venture capital in the Midwest, nationally and globally. Kirkland partner Bruce I. Ettelson, P.C., will moderate a panel of venture GPs titled "The Risks & Rewards of Driving Investing in New Corporate Growth: How Venture Capital Firms are Navigating the Waters Going Forward." The panelists will discuss the current fundraising environment for venture funds and its implications for venture capital financing transactions.

Infoline's "Private Equity Regulation & Compliance Conference"**London, UK****May 25, 2010**

This conference, hosted by Infoline, will provide a practical update on regulatory and compliance developments for private equity firms. Kirkland partners Lisa Cawley and Stephanie Biggs will speak on "An Overview of U.S. Changes in Regulation Impacting Private Equity Firms."

The International Bar Association's "9th Annual Mergers & Acquisitions Conference"**New York, New York****June 16-17, 2010**

The 9th Annual International Mergers & Acquisitions Conference, hosted by the International Bar Association, will focus on significant trends and developments in mergers and acquisitions. Kirkland partner David Fox will speak on the panel titled "Private Equity Today." The panel will discuss the legal issues in representing private equity firms in the current environment, including alternative forms of financing, PIPE financings, co-investments and the future of regulation of private equity.

Chicago

Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
+1 (312) 862-2000
+1 (312) 862-2200 fax

Hong Kong

Kirkland & Ellis LLP
26th Floor
Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
+852-3761-3300
+852-3761-3301 fax

London

Kirkland & Ellis
International LLP
30 St Mary Axe
London, EC3A 8AF
United Kingdom
+44 20 7469 2000
+44 20 7469 2001 fax

Los Angeles

Kirkland & Ellis LLP
333 South Hope Street
29th Floor
Los Angeles, CA 90071
+1 (213) 680-8400
+1 (213) 680-8500 fax

Munich

Kirkland & Ellis
International LLP
Maximilianstrasse 11
80539 Munich
Germany
+49 89 2030 6000
+49 89 2030 6100 fax

New York

Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
+1 (212) 446-4800
+1 (212) 446-4900 fax

Palo Alto

Kirkland & Ellis LLP
950 Page Mill Road
Palo Alto, CA 94304
+1 (650) 859-7000
+1 (650) 859-7500 fax

San Francisco

Kirkland & Ellis LLP
555 California Street
San Francisco, CA 94104
+1 (415) 439-1400
+1 (415) 439-1500 fax

Shanghai

11th Floor, HSBC Building
Shanghai IFC
8 Century Avenue
Pudong New District
Shanghai 200120
P.R. China
+8621 3857 6300
+8621 3857 6301 fax

Washington, D.C.

Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
+1 (202) 879-5000
+1 (202) 879-5200 fax

Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. Kirkland received the 2009 and 2008 awards for Best Law Firm (Private Equity Deals) in North America from *Private Equity International*. In *Buyouts Yearbook 2010*, Kirkland was named "Best Law Firm." Additionally, Mergermarket ranked Kirkland first by volume for North American Buyouts and Exits in its "North American Private Equity in Review for 2009," and Pitchbook named Kirkland as one of the most active law firms representing private equity firms in its "Private Equity Breakdown" in 2009.

The Lawyer magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008, 2009 and 2010, noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

KIRKLANDPEN

KIRKLAND & ELLIS LLP

EDITORS

Jack S. Levin, P.C.

Margaret A. Gibson, P.C.

Norbert B. Knapke II

SUBSCRIPTIONS

To subscribe to *KirklandPEN*, please e-mail

kirklandpen@kirkland.com

This publication is distributed with the understanding that the author, publisher and distributor of this publication and/or any linked publication are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to applicable rules of professional conduct, portions of this publication may constitute Attorney Advertising.