



## Latest Obama Administration Proposal to Tax Carried Interest as Ordinary Income

*September 16, 2011*

### **SUMMARY**

On September 12, 2011, the Obama Administration submitted legislation to Congress in the American Jobs Act that would tax income from carried interests at ordinary rates. The Administration's proposal on carried interest is similar to proposed legislation previously passed by the House of Representatives and considered by the Senate, although, as described below, there are several differences from those earlier proposals. While enactment of carried interest legislation seems unlikely this year, the proposal presumably reflects the Administration's intended course on carried interest and follows prior statements by the Administration in support of the earlier proposals.

### **PROPOSED GENERAL RULES**

The proposed legislation would treat income and gain attributable to "investment services partnership interests" (ISPIs) as ordinary income. Unlike prior proposals, there would not be a blended ordinary/capital gain rate that would apply to the recharacterized income and gain. Rather, all such income and gain would be taxed at ordinary income rates and would also be subject to the self-employment tax. The proposed legislation would generally prevent transfers of an ISPI from qualifying for otherwise available nonrecognition treatment, with exceptions for certain transfers to charities or persons with respect to whom the transferred interest would be an ISPI. As in prior proposals, income and gain attributable to certain qualified capital interests would not be subject to recharacterization. The proposed legislation would be effective for taxable years ending after December 31, 2012, and would apply to dispositions of ISPIs after December 31, 2012.

### **WHAT WOULD BE COVERED?**

The proposed legislation is more targeted in certain respects than the prior proposals. For the proposed legislation to apply to an interest in a partnership:

- Substantially all of the assets of the partnership (other than certain intangible assets such as goodwill) must be "specified assets" (such as securities, real estate, etc.).
- More than half of the contributed capital of the partnership must be attributable to contributions by one or more persons in whose hands the partnership's interests constitute property held for the production of income (as opposed to held as part of a trade or business). The purpose is presumably to limit ordinary income treatment to cases where the carry is earned primarily on capital from passive investors, but the proposed legislation does not clearly define that concept.
- The carried interest must be held or acquired in connection with the conduct of a business primarily involving the performance of investment, advisory and management services in respect of specified assets.

## ENTERPRISE VALUE

There is no express exception to ordinary income treatment for the “enterprise value” of an investment partnership (that is, the value attributable to goodwill in the fund sponsor’s business), although it is possible that some enterprise value relief from ordinary income treatment would result from the new “investment partnership” concept and the associated requirement that more than half of the capital of such a partnership be contributed by persons who hold their interests for the production of income. However, when compared to estimates for the prior proposals, the \$18 billion revenue estimate associated with the latest proposal may suggest that enterprise value relief was not intended.

## PUBLICLY TRADED PARTNERSHIPS; TIERED PARTNERSHIPS

The proposed legislation would characterize certain income and gain in respect of ISPIs as non-qualifying income under the tax rules applicable to publicly traded partnerships after a ten-year transition period from the effective date.

The proposed legislation contains special rules for tiered partnerships. Under these rules, gain on the sale of interests in an upper-tier partnership would generally be recharacterized as ordinary income to the extent attributable to ISPIs held by the upper-tier partnership or other lower-tier partnerships. As a result, gain on the sale of interests in a publicly traded partnership may be treated as ordinary income to the extent attributable to carried interests held in partnerships directly or indirectly owned in flow-through form by the publicly traded partnership.

\* \* \*

For more information about these proposed rules, please contact one of the following members of the Firm’s Tax Department.

John J. Creed  
(212) 455-3485  
[jcreed@stblaw.com](mailto:jcreed@stblaw.com)

Marcy G. Geller  
(212) 455-3543  
[mgeller@stblaw.com](mailto:mgeller@stblaw.com)

John C. Hart  
(212) 455-2830  
[jhart@stblaw.com](mailto:jhart@stblaw.com)

Steven C. Todrys  
(212) 455-3750  
[stodrys@stblaw.com](mailto:stodrys@stblaw.com)

*This memorandum is for general informational purposes and should not be regarded as legal advice. Furthermore, the information contained in this memorandum does not represent, and should not be regarded as, the view of any particular client of Simpson Thacher & Bartlett LLP. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda, can be obtained from our website, [www.simpsonthacher.com](http://www.simpsonthacher.com).*

***IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this memorandum was not intended or written to be used, and cannot be used, for the purpose of avoiding tax-related penalties under federal, state or local tax law. Each taxpayer should seek advice based on the taxpayer’s particular circumstances from an independent tax advisor.***

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication.

## UNITED STATES

### New York

425 Lexington Avenue  
New York, NY 10017-3954  
+1-212-455-2000

### Houston

2 Houston Center – Suite 1475  
Houston, TX 77010  
+1-713-821-5650

### Los Angeles

1999 Avenue of the Stars  
Los Angeles, CA 90067  
+1-310-407-7500

### Palo Alto

2550 Hanover Street  
Palo Alto, CA 94304  
+1-650-251-5000

### Washington, D.C.

1155 F Street, N.W.  
Washington, D.C. 20004  
+1-202-636-5500

## EUROPE

### London

CityPoint  
One Ropemaker Street  
London EC2Y 9HU  
England  
+44-(0)20-7275-6500

## ASIA

### Beijing

3919 China World Tower  
1 Jian Guo Men Wai Avenue  
Beijing 100004  
China  
+86-10-5965-2999

### Hong Kong

ICBC Tower  
3 Garden Road, Central  
Hong Kong  
+852-2514-7600

### Tokyo

Ark Mori Building  
12-32, Akasaka 1-Chome  
Minato-Ku, Tokyo 107-6037  
Japan  
+81-3-5562-6200

## SOUTH AMERICA

### São Paulo

Av. Presidente Juscelino Kubitschek, 1455  
12th Floor, Suite 121  
São Paulo, SP 04543-011  
Brazil  
+55-11-3546-1000