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The Biden Administration Re-Proposes to Tax Carried Interests as Ordinary Income

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On March 28, 2022, the Biden Administration proposed to tax “profits” or “carried” interests as ordinary income and impose self-employment tax on income and gains from these interests for certain partners in investment partnerships. The proposal is identical to the proposal made by the Administration last year.

Under current law, a “carried” or “profits” interest in a partnership received in exchange for services is generally not taxable when received and the recipient is taxed on their share of partnership income based on the character of the income at the partnership level. Section 1061 requires certain carried interest holders to satisfy a three-year holding period – rather than the normal one-year holding period – to be eligible for the long-term capital gain rate.

Under the Biden Administration’s proposal, a partner’s share of income on an “investment services partnership interest” (an “ISPI”) in an investment partnership would generally be taxable as ordinary income, and gain on the sale of an ISPI would be taxable as ordinary income if the partner’s taxable income (from all sources) exceeds $400,000. [1] The proposal suggests that income or gain attributable to goodwill or other assets unrelated to the provision of services will not be taxed as ordinary income, and the Administration intends to develop mechanisms with Congress to determine how much of the income or gain from an ISPI should be recharacterized.

The Biden Administration would define an ISPI as “a profits interest in an investment partnership that is held by a person who provides services to the partnership”. This definition is broader than section 1061, which applies to interests in partnerships in the business of “raising or returning capital” and investing or developing“specified assets” (generally limited to investment-type assets).

Under the Administration's proposal, a partnership would be considered an "investment partnership" if substantially all of its assets are investment-type assets (which are similar to the "specified assets" definition of section 1061), but only if more than 50% of the partnership's contributed capital is from partners to whom the interests constitute property not held in connection with a trade or business.

The purpose and meaning of the exception provided by this 50% test is unclear. Assume that insurance companies contribute cash from their reserves to an investment partnership in exchange for partnership interests, and the general partner of that partnership receives a carried interest in exchange for managing the assets of the partnership. The partnership interests received by the insurance companies would appear to be reserves held in connection with their trade or business of providing insurance. It appears that the general partner would not be subject to the Administration's proposal or, as discussed below, section 1061, and therefore could receive allocations of long-term capital gain based upon a one-year holding period.

Under the Administration's proposal, if a partner who holds an ISPI also contributes "invested capital" (generally money or other property, but not contributed capital attributable to the proceeds of any loan or advance made or guaranteed by any partner or the partnership or a related person) and holds a "qualified capital interest" in the partnership, income attributable to the invested capital, including the portion of gain recognized on the sale of an ISPI attributable to the invested capital, would not be subject to recharacterization.

"Qualified capital interests" would generally require that (a) the partnership allocations to the invested capital be made in the same manner as allocations to other capital interests held by partners who do not hold an ISPI and (b) the allocations to these non-ISPI holders be significant. The "same manner" requirement would be a return to the language used in the section 1061 proposed regulations, which was ultimately relaxed to a "similar manner" requirement in the final regulations. The proposal's requirement that allocations to non-ISPI holders be "significant" is also a divergence from the final section 1061 regulations, which look to whether the capital contributed by "Unrelated Non-Service Partners" is significant.

The Administration's proposal would also require partners to pay self-employment tax on ISPI income.

In addition, under an anti-abuse rule of the proposal, any person above the income threshold who performs services for any entity (including entities other than partnerships) and holds a “disqualified interest” in the entity would be subject to tax at “rates applicable to ordinary income” on any income or gain received with respect to the interest.

A “disqualified interest” would be defined as convertible or contingent debt, an option, or any derivative instrument with respect to the entity (but does not include a partnership interest, stock in certain taxable corporations, or stock in an S corporation). Thus, under the proposal, if an employee received a note as compensation from a C corporation, any gain on the sale of the note would be taxable at ordinary income rates (but, apparently, would not be treated as ordinary income so the gain could be offset by capital losses). The anti-abuse rule provides that capital gain subject to it is taxable “at rates applicable to ordinary income,” but does not provide that the capital gain is ordinary income. It is unclear why this rule is different than the rule that applies to ISPIs, but it would allow capital losses of the taxpayer to offset the capital gains.

The proposal notes that it is not intended to adversely affect qualification of a REIT owning a profits interest in a real estate partnership.

The proposal would repeal section 1061 for taxpayers whose taxable income (from all sources) exceeds $400,000 and would be effective for taxable years beginning after December 31, 2021. Taxpayers whose taxable income is $400,000 or less would be subject only to section 1061. If the proposal were to become law, we expect that sponsors of funds will be more likely to receive their compensation in the form of deferred fees rather than as a carried interest.

The Administration’s proposal appears to be based on the Carried Interest Fairness Act of 2021, the February 2021 House bill (the “House Bill”) introduced by Bill Pascrell (NJ) and co-sponsored by Andy Levin (Michigan) and Katie Porter (California).

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[1] The House of Representatives' September 2021 version of the Build Back Better Act (the "BBBA") would have extended the holding period to qualify for long-term capital gains for carried interests from three to five years for holders with an adjusted gross income in excess of $400,000 per year. However, the proposal was not included in the October 2021 version of the BBBA (which contained no carried interest proposals). For more information about the BBBA, read our prior blog post here.

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