

CLIENT ALERT

# New Legislative Proposal on Taxation of Carried Interest

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On August 5, 2021, the Ending the Carried Interest Loophole Act (the “Act”) was introduced in the Senate. Under the Act, a manager is required to recognize a deemed compensation amount annually, taxed at ordinary rates, and subject to self-employment taxes. Generally, the Act calculates a fund manager’s deemed compensation amount by applying a standard rate of return to the portion of the investors’ capital that is deemed to be used to invest for the manager’s own account. Stated differently, the Act analogizes the carried interest to an interest-free loan from the investors to the manager, and the deemed compensation amount is the estimated forgone interest. The fund manager also realizes a long-term capital loss equivalent to the deemed compensation amount.

Specifically, the deemed compensation amount is calculated and recognized annually and can be expressed with the following formula:  $\text{Deemed Compensation Amount} = \text{Specified Rate} \times ((\text{Applicable Percentage} \times \text{Invested Capital of all partners}) - \text{Invested Capital of the tested partner})$ . The Specified Rate is the par yield for 5-year High Quality Market corporate bonds (currently 1.21%) for the first month of the calendar year with or within which the partnership’s tax year begins plus nine percentage points. The Applicable Percentage with respect to any applicable partnership interest is the highest percentage of profits of the partnership that could be allocated with respect to the partner (consistent with the partnership agreement, determined as if all performance targets with respect to such interest had been met, taking into account applicable catch-up mechanisms). Invested Capital generally equals a partner’s book capital account, with certain modifications. For example, assuming a Specified Rate of 10% and an Applicable Percentage of 20%, if a partnership has \$1,000 of Invested Capital in 2021, and the manager has zero Invested Capital, the manager would have a \$20 deemed compensation inclusion for that taxable year, regardless of whether the partnership makes a distribution.

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The Act applies to a partner of a partnership in which the partner holds one or more applicable partnership interests. An applicable partnership interest is any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with the performance of services in any applicable trade or business. An applicable trade or business is any activity that consists in whole or in part in raising or returning capital, and either (1) investing in (including acquiring or disposing of) specified assets (or identifying specified assets for such investment, acquisition, or disposition), or (2) developing specified assets. Specified assets generally include securities, commodities, real estate held for rental or investment, cash or cash equivalents, and options or derivative contracts with respect to the foregoing, as well as an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.

Additionally, the Act amends Section 83 of the Code to value at issuance a compensatory partnership interest based on its liquidation value. An amount included in income under this version of Section 83 would serve to reduce a partner's deemed compensation amount. Rev. Procs. 93-27 and 2001-43 will not apply to the transfer of a partnership interest to which the Act applies. Finally, the Act would also repeal Sec. 1061 of the Code.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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