New Proposals to Tax Carried Interest as Ordinary Income Garner Bipartisan Support

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On March 4, 2014, President Obama issued his Administration's Fiscal Year 2015 Budget, which includes a proposal to tax carried interests (also known as "performance allocations" or "incentive allocations") in investment partnerships (such as hedge funds and private equity funds) at ordinary income rates. This is the fifth straight year in which the President has proposed tax reform relating to carried interests in investment partnerships. In a bipartisan departure from prior years, House Ways and Means Committee Chairman Dave Camp (R-MI) released draft tax reform legislation last week that also contained a proposal to tax income and gain attributable to carried interests in investment partnerships at ordinary income rates.

Under current law, the character of a partnership's income and loss is determined at the partnership level, and the character of such income or loss passes through to the partners. As a result, an individual partner is taxed at a maximum federal income tax rate of 23.8 percent (the current maximum 20 percent long-term capital gain rate and an additional 3.8 percent on certain net investment income) on long-term capital gain or qualified dividend income that is allocated to him or her. In the case of an investment partnership, however, both proposals would treat any allocation of income with respect to a carried interest that is not attributable to capital invested by the partner, and any gain recognized on the sale of such an interest, as ordinary income, subject to a maximum income tax rate of 39.6 percent (under current law) or 35 percent (under Rep. Camp's proposal), regardless of the character of the underlying income at the partnership level.

In addition, the Obama Administration's proposal provides that income and gain attributable to such carried interests would be subject to self-employment taxes (3.8 percent, assuming the applicable Medicare surtax threshold has been reached). Rep. Camp's proposal, on the other hand, would not treat such carried interest income and gain as compensation (and, therefore, would not treat such income and gain as being subject to self-employment taxes); however, such income likely still would be subject to the 3.8 percent net investment income tax, which would be unaffected by Rep. Camp's proposed legislation.

The Obama Administration stated that carried interest not attributable to capital invested by the partner should be taxed as ordinary income and subject to self-employment tax because such income is derived from the performance of services, and allowing service partners in investment partnerships the opportunity to receive long-term capital gains treatment on services income creates an unfair and inefficient tax preference. Similarly, in an op-ed published in the Wall Street Journal on February 25, 2014, Rep. Camp stated: "We can clean up provisions like 'carried interest' that allow certain [partners in investment partnerships] to get the investment-income tax rate on what anyone else would call normal wage income."

If enacted into law, the President's proposal or Rep. Camp's draft legislation would be effective beginning in 2015.

Despite the current bipartisan support for carried interest tax reform, political pundits are skeptical that either of the current proposals will gain traction before the 2014 mid-term elections. Nevertheless, as lawmakers look for new ways to generate revenue, these proposals may move up the agenda in Washington. We will monitor the progress of these proposals and will provide more detail if any significant developments occur.

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