President Obama's 2014 Budget Proposes to Tax Carried Interest as Ordinary Income

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Yesterday, President Obama issued his Administration's Fiscal Year 2014 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.

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 income tax rate of 20 percent (the current maximum long-term capital gain rate) on long-term capital gain or qualified dividend income that is allocated to him or her. In the case of an investment partnership, however, the proposal would treat any allocation of income that is not attributable to capital invested by the partner as ordinary income, subject to a maximum income tax rate of 39.6 percent, regardless of the character of the underlying income at the partnership level.

In addition, the proposal provides that carried interest income will be subject to self-employment taxes, and the gain recognized on the sale of a carried interest that is not attributable to capital invested by the partner would be taxed as ordinary income rather than as capital gain.

If enacted into law, the proposal would be effective beginning in 2014.

We will monitor the progress of this proposal as the President's Budget is considered by Congress, and we will provide more detail if any legislation is proposed.

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