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American Jobs Act's Ordinary Income Tax Treatment of "Carried Interests" Broader Than Prior Proposals

President Barack Obama's proposed American Jobs Act of 2011 (the jobs act) would characterize all carried interest income earned by an investment manager as ordinary income beginning in January 2013 and treat the full amount as self-employment income subject to Social Security and Medicare taxes.

This proposal differs from the one passed by the House of Representatives and considered by the Senate in 2010 in that the earlier proposal would have treated only a portion of the carried interest as ordinary income. By contrast, the jobs act would tax 100 percent of the relevant income as ordinary and would allow capital gains treatment only for that portion of the income attributable to the manager's own invested capital.

Under current law, income derived from an investment manager's carried interest generally has the same tax character as income does at the partnership level and therefore is commonly subject to tax at more favorable long-term capital gains rates. Such income also is not subject to the other taxes imposed on self-employment income, including the 2.9 percent Medicare tax, which, unlike the Social Security tax, has no cap.

The jobs act proposes to add a new Section 710 to the Internal Revenue Code of 1986, as amended (the Code), that would tax as ordinary income the net income derived from an "investment services partnership interest" - defined broadly as an interest in an investment partnership (such as a hedge fund, private equity fund or other pooled investment vehicle) held or acquired by an investment manager in connection with the investment manager's (or a related person's) conduct of a trade or business that primarily involves providing certain investment management services to the partnership.

To prevent circumvention of the basic rule, the jobs act also will apply ordinary income treatment both to the gain realized on the sale of an investment services partnership interest (excluding certain gifts to charity) and to the appreciation in value of securities and other property distributed in-kind with respect to a carried interest. Carried interest income also would be deemed net earnings from self-employment and therefore subject to Social Security and Medicare taxes.

The jobs act generally would not apply to income and gain derived from an investment manager's "qualified capital interest," which is the investment manager's interest as a partner attributable to (a) the fair market value of any money or other property contributed to the partnership in exchange for such interest, (b) any amounts that have been included in gross income under Code Section 83 with respect to the transfer of such interest, and (c) the excess (if any) of items of income and gain over items of deduction that are taken into account with respect to the interest. A qualified capital interest would not include any interest purchased with the proceeds of a loan or other advance made or guaranteed by the partnership or another partner.

Although Congress has consistently rejected or stalled previous proposals to tax carried interest as ordinary income, the jobs act proposal may have a greater likelihood of passage because its potential as a revenue-generating mechanism may appeal to members of the Joint Select Committee on Deficit Reduction, commonly known as the "Super Committee." President Obama has charged the Super Committee with raising the revenue offsets for the jobs act as part of its broader deficit-reduction mandate. The Super Committee can fast-track the jobs act (and therefore the carried interest proposal) through Congress, without opportunity for amendment and filibuster and requiring a simple majority vote for approval. The Super Committee is under significant pressure to recommend revenue-raising proposals like those in the jobs act to fulfill its obligation to submit a deficit-reduction plan that achieves $1.5 trillion in savings over a 10-year period.

If enacted, the effective date of the jobs act would be January 1, 2013.