

PRIVATE EQUITY FUNDS CARRIED INTEREST WILL LIKELY BE TAXED AS ORDINARY INCOME UNDER LEGISLATION NOW MOVING TOWARD PASSAGE

But There May Be Tax Strategies That Can Reduce the Impact

Congress is closer than ever to shifting the tax treatment of a substantial portion of private equity and hedge fund carried interests from capital gains to ordinary income.

Since 2007, there has been pressure in Congress to make this change in tax treatment in order to tax, at a higher rate, a larger share of general partners' carried interest. The House of Representatives passed such a change in each of the past three years, but each time, it was held up by the Senate.

This year, it's likely to be different, as Congress seeks to raise revenue from increasing the taxes on compensation in the financial services industry following the financial crisis.

On May 28, the House of Representatives passed the American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213). The bill includes a new provision, Section 710 ("Proposed Carried Interest Legislation"), which would tax carried interests in the following proportions: 50 percent ordinary income and 50 percent capital gains for 2011 and 2012; and 75 percent ordinary income and 25 percent capital gains beginning in 2013. The carried interest would also be subject to self employment taxes.

Meanwhile, the Senate Finance Committee, under Chairman Sen. Max Baucus, has

been actively seeking a compromise that could garner enough support for passage by the Senate. Baucus has announced his latest proposal for the tax treatment of carried interests: 75 percent ordinary income and 25 percent capital gains, beginning in 2011. Baucus' original proposed bill would have taxed carried interest as 65 percent ordinary income, 35 percent capital gains beginning in 2013, with a temporary transition ratio of 50-50 for 2011 and 2012.

Although a Senate version seems likely to eventually emerge and potentially pass, further compromises are likely before the bill can emerge from the committee.

Are There Strategies That Might Avoid Ordinary Income Treatment Under the New Law?

There is little doubt that many efforts will be made to devise strategies that avoid or minimize the impact of the proposed law. And indeed, efforts are

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While the latest version provides more stringent treatment of carried interest from the sale of *shorter-term assets*, it also provides a more generous exception for the sale of *longer-term assets*. In the case of the sale of assets held more than five years, the carried interest would be taxed at 50 percent ordinary income, 50 percent capital gains.

The Baucus proposals concerning carried interest were lumped in with other proposed tax changes, including one that narrows the scope of a provision that would require shareholder employees of a personal service S corporation to pay self employment tax on their full share of allocated earnings.

already under way in advance of the expected passage of the new legislation.

One potential tax savings strategy might be to distribute securities to the general partner prior to 2011. This may prove beneficial if the fund has built up long term capital gains and the general partner also has built up unrealized gains in his or her capital account.

Another possible strategy could be as simple as recognizing the long terms that currently exist in the fund. This could potentially accelerate income but at a lower tax rate than if recognized as part of a carried interest post 2010.

With the Government seeking different ways to increase its revenues and reduce the Federal deficit, tax planning has become vital for investment managers.

To learn more about the proposed carried interest taxation, please contact Warren Abkowitz, CPA, JD, MST, a J.H. Cohn partner and a member

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TAXING TIMES — A STATE PERSPECTIVE

To a casual observer, the economy is rapidly gaining strength. Consumer spending is increasing, the economy has added almost one million jobs during the first five months of 2010, and credit is becoming more readily available. From a state tax budget perspective, however, the future is not as optimistic and many states will continue to operate at a deficit into the foreseeable future unless revenues increase and/or expenditures decrease. Simply put, most states have not been able to react quickly enough to counteract the negative effects (specifically the decreases in employment and consumer spending) the recession has had and will continue to have on their budgets. For portfolio companies doing business in a variety of states, this has a profound impact on operations and, ultimately, earnings and rate of return.

Most states receive the majority of their revenue, approximately 74 percent, from three tax types: sales/use (“SUT”), personal income (“PIT”), and corporate income (“CIT”).¹ These taxes accounted for approximately 31 percent, 36 percent, and seven percent, respectively, of the \$781 billion in tax collected during 2008.² Despite adding almost one million jobs to date during 2010, the economy has 7.4 million fewer jobs now than when the recession began. Because the largest revenue source for the states is derived from the remittance of individual income taxes, and the number of jobs in the U.S. are significantly lower than when the recession began, it will be some time before this revenue source recovers. Also, although Gallup reported that consumer spending reached the highest levels in the past 17 months,³ the states’ second largest revenue stream, sales and use taxes, will also likely be below pre-recession levels for some time.

Preliminary tax data for the first quarter of 2010 reflects an overall increase in state tax collections of \$3.2 billion, or 2.4 percent, over the same quarter in 2009.⁴ Even with this increase, and significant to this discussion, state tax revenue overall is down 10.9 percent as compared to the same quarter in 2008.⁵ The following table reflects, by major tax-type and for total taxes, the percent change in state tax collections as compared to the same quarter in the prior year⁶:

Quarter Ended	SUT	CIT	PIT	Total
Q1-2010 (estimated)	0.5	2.3	2.7	2.4
Q4-2009	(5.3)	(3.6)	(4.6)	(4.2)
Q3-2009	(10.0)	(22.6)	(11.9)	(11.4)
Q2-2009	(9.5)	0.8	(27.0)	(16.5)
Q1-2009	(8.3)	(20.1)	(17.4)	(11.6)

As indicated above, it appears that state tax revenues are stabilizing, but overall, state tax revenues are still significantly below pre-recession levels.

So, what are states doing in response to this significant revenue reduction? Many are enacting “tax amnesty” programs to raise revenue, proposing budget cuts, furloughing employees, using rainy-day funds, and relying on accounting tricks (such as accelerating estimated tax payments) to help close budget gaps.

States are also increasing taxes, some of which are only temporary, and imposing new taxes. States have already enacted roughly \$24 billion in state tax increases for their FY2010 revenue year, with roughly half of these changes relating to increases in personal income taxes.⁷ In fact, California and New York have already enacted significant tax increases, which are briefly discussed below and, if the results from both of these states were excluded from the above table, Q1-2010

state tax revenues would show a 2.2 percent decrease as compared to Q1-2009.⁸ This data highlights that many states still have not taken the steps necessary to balance their budgets and, even with the tax changes already enacted in California and New York, both states still face significant budget deficits.⁹

During 2009, at least nine states increased their personal income tax rates, some with significant tax rate increases: Connecticut increased its highest marginal income tax

1 U.S. Bureau of the Census, State Government Tax Collections: 2008.

2 *Id.*

3 Gallup (June 9, 2010). *Consumer Spending, Job Creation Near 17-Month Highs.*

4 Dayden, Lucy (2010). *Overall State Tax Revenue is Up, But Losers Still Outnumber Gainers.* The Nelson A. Rockefeller Institute of Government.

5 *Id.*

6 *Id.*

7 Boyd, Donald J., (2010). *Recession, recovery, and state-local finances.* The Nelson A. Rockefeller Institute of Government.

8 Dayden, Lucy, *supra*, note 4.

9 California currently projects a \$20 billion deficit for its 2009/2010 and 2010/2011 budget years, *The 2010-11 Budget: California's Fiscal Outlook*, California Legislative Analyst's Office (November 18, 2009) and New York State currently projects a \$7.4 billion deficit for its 2010/2100 budget year, *NYS DBO: Press Release – 2010-11 Executive Budget* (January 19, 2010).

rate by 30 percent (from 5.0 percent to 6.5 percent), New York eliminated most itemized deductions for certain taxpayers and increased its highest marginal income tax rate by 29 percent (from 6.95 percent to 8.97 percent), and New Jersey increased its highest marginal income tax rate by 20 percent (from 8.97 percent to 10.75 percent). With personal income taxes now accounting for nearly forty-percent of all state tax collections, many of us can expect to see an increase in our state income tax liabilities (not to mention the looming federal individual income tax increases that are likely forthcoming).

States are also significantly increasing their sales tax rates, with California increasing its state sales tax rate by nearly 14 percent (from 7.25 percent to 8.25 percent), Massachusetts by 30 percent (from five percent to 6.25 percent) and North Carolina by nearly 28 percent (from 4.5 percent to 5.75 percent). We've also seen Colorado, New York, North Carolina, and Rhode Island pushing economic nexus filing requirements for sales tax purposes to new extremes. These states may be short-sighted, however, as Amazon and Overstock terminated all web-marketing relationships with firms within each of these states, causing at least an initial negative impact on such states' economies.¹⁰ The companies also

threatened to terminate their relationships with California and Hawaii web-marketing firms if those states adopted similar economic nexus rules. Oklahoma has also recently enacted similar rules.

With respect to corporate income taxes, Massachusetts and Wisconsin have recently adopted unitary tax legislation (whereby a group of affiliated companies, provided certain intercompany relationships exist, is treated as a single company for corporation income tax purposes). In reality, however, with many corporations generating little taxable income, we don't expect such changes to raise significant state revenue for the current state budgets.

We've also seen one significant new tax: The New York "Metropolitan Commuter Transportation Mobility Tax," which is a new payroll tax on employers with employees working in and around New York City. More new taxes are likely on the horizon, especially with most state legislatures now in session.

Today, many economists believe the economy is strengthening¹¹ and many people believe that the worst is behind us. I certainly hope that this is true. However, from a state budget standpoint, more needs to be done to improve the fiscal health of state government. As noted above, even with significant tax increases already enacted, we can expect to see significant budget shortfalls unless the states further increase taxes or reduce expenditures. In fact, The Center on Budget and Policy Priorities projects budget shortfalls of up to \$375 billion for the 2010 and 2011 years.¹² Although many states seem to be reluctant to decrease spending or increase taxes, the only way to effectively combat these shortfalls is through a combination of spending reductions and tax increases. This is sure to be an interesting summer as state legislatures across the country begin grappling with these issues. ■

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¹⁰ Henchman, Joseph (2010). "Amazon Tax" Laws Signal Business Unfriendliness and Will Worsen Short-Term Budget Problems. The Tax Foundation.

¹¹ Dadayan, Lucy (2010). Final Quarter of 2009 Brought Still More Declines in State Tax Revenue. The Nelson A. Rockefeller Institute of Government.

¹² McNichol, Elizabeth and Johnson, Nicholas (2010). Recession Continues to Batter State Budgets; State Responses Could Slow Recovery. Center on Budget and Policy Priorities.

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