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House of Representatives Passes Carried Interest and Foreign Account Reporting and Withholding Legislation

TO: Clients and Friends
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On December 9th, the House passed H.R. 4213 ("The Tax Extenders Act of 2009"). This bill would extend through the end of 2010 a package of 49 tax relief provisions that are otherwise slated to expire at the end of 2009. Of particular interest to investment funds, the bill also includes, as revenue offsets for these extensions, provisions (i) taxing "carried interests" at ordinary income rates and (ii) expanding the reporting and withholding requirements with respect to foreign financial accounts and entities. While it is unclear at this time whether or not these provisions will be accepted by the Senate and included in the final legislation, investment funds and their managers should be aware that at least the carried interest proposal may become effective for the 2010 tax year.

I. Carried Interest Proposal.

The Tax Extenders Act would tax income and gains associated with certain "carried interests" as ordinary income. These provisions in the bill are substantially identical to those included in Representative Sander Levin's carried interest bill introduced earlier this year. The bill proposes to impose ordinary income tax rates on profit allocations (sometimes called "performance allocations" or "incentive allocations") to investment fund managers or general partners (other than any allocable income or gain that is properly attributable to an interest received in respect of contributed money or property), and would subject such profits to self-employment tax. Under this legislation, a general partner's carried interest allocations in an investment fund would be subject to the higher ordinary income tax rate, regardless of the character of the income to the fund. Similarly, gains on the disposition of the general partner's interest in such carried interest allocations, as well as on the disposition of any interest in the general partner entity, would be taxed as ordinary income. The bill contains certain anti-avoidance rules and imposes significant penalties for violation of such rules.

If the legislation is enacted, these provisions would be effective for tax years ending after 2009. It should be noted that the carried interest provisions in the bill would not apply to partnerships that develop real property for sale, rather than hold real property for rental or for investment purposes (the two types of real estate holdings covered by the bill).

II. Reporting and Withholding Proposals.

The bill would impose a 30% withholding tax on payments of U.S. source income to accounts owned by U.S. persons in foreign financial institutions, unless those institutions agree to comply with certain information gathering and reporting procedures with respect to those accounts. Similar rules in the bill also apply to payments of U.S. source income to certain foreign entities having U.S. owners. The types of payments subject to withholding under the bill are expanded in these cases to include payments of gross proceeds from the disposition of any property that can produce U.S.-source interest or dividends.

In addition, the legislation would treat certain "dividend equivalent" payments as dividends for tax purposes. This would generally subject to U.S. withholding tax certain notional principal contract (swap) payments and other substitute payments that are economically similar to dividends but currently avoid U.S. tax. The bill also gives the Internal Revenue Service authority to require annual information reporting by U.S. shareholders of a passive foreign investment company (a so-called "PFIC").

Various effective dates would apply to the reporting and withholding provisions of the bill. Certain aspects would be effective for taxable years beginning after the date of enactment, while others would become effective two years after enactment.

We will monitor the bill's progress in the Senate and provide further details as the bill moves closer to enactment.

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