

Carried Interest Would Be Taxed at Ordinary Income Tax Rates Under Newly Proposed Legislation

On July 27th, Senate Majority Leader Chuck Schumer and Senator Joe Manchin issued a joint statement announcing an agreement to add the Inflation Reduction Act of 2022 to the FY2022 Budget Reconciliation Bill. The act includes changes to the rules for carried interest that are designed to severely limit the ability of Private Equity managers to benefit from capital gains treatment on their carried interest.

Carried Interest Proposal

The proposed changes to the carried interest rules in section 1061 are similar to those that were proposed in the Build Back Better Act in September 2021 and could significantly limit favorable tax treatment of carried interests for high-earner PE/VC professionals:

- 1. Longer Holding Period:** The holding period required for high-earner PE/VC investment professionals to avoid unfavorable short-term capital gain (STCG) treatment on their carried interests would be significantly longer than the current 3-year holding period. The new required holding period would be 5 years *after* the fund acquires substantially all of its investments (or if later, after the date when the investment professional acquires substantially all of the carry). *Practically, given the typical investment period of PE/VC funds, the new required holding period could be significantly longer than 5 years with respect to investments acquired early in the fund's investment period (e.g., if the fund acquires substantially all of its investments over 4 years, the 5-year holding period would not start for any investments made by the fund until the last investment is made in year 4.)*
- 2. Broader Scope:** The proposal would expand the type of gain/income from carried interests that are subject to the holding period rules applicable to carried interest. Under the proposal, gain from the sale of active business assets (section 1231 gain) and "qualified dividend income" could be subject to STCG treatment if the holding period for carried interest is not satisfied. *Practically, this change could result in unfavorable STCG treatment for carried interest with respect to sales of pass-through Portfolio Companies and dividend recapitalizations, which otherwise might not have been subject to the longer holding period requirements.*
- 3. Limitation on Structuring Solutions:** The proposal directs the Treasury to issue regulations to prevent the avoidance of STCG treatment under section 1061. It specifically identifies certain structuring solutions that have been used by taxpayers to limit the application of 1061 (including in-kind distributions and carry waivers).
- 4. Loss of Non-recognition Treatment on Transfers of Carried Interest:** The proposal includes language requiring gain recognition where a taxpayer transfers carried interest, notwithstanding other provisions under the Code that would otherwise provide for non-recognition treatment. *Practically, this could require gain recognition not only on a contribution of carried interest to a new partnership or other non-taxable partnership restructuring transfers, but could also be required upon transfers of partnership interests by gift or at death. Presumably, completed gifts made prior to the effective date of the proposal would not be subject to this rule, although that could change.*
- 5. Effective Date:** The proposal would apply to taxable years beginning after December 31, 2022.

Please contact a member of Choate's Private Equity or Wealth Management Group if you are interested in exploring any of these opportunities further.

Private Equity Team

William Gelnow, Jr.

Managing Partner
617-248-5034 | wgelnow@choate.com

T.J. Murphy

Practice Group Leader
617-248-5152 | tmurphy@choate.com

Brian Lenihan

Department Co-Chair – Business
617-248-4929 | blenihan@choate.com

Rees Hawkins

Partner
617-248-4777 | rhawkins@choate.com

Oliver Leger

Partner
617-248-4058 | oleger@choate.com

Gustavo Resendiz

Partner
617-248-4708 | gresendiz@choate.com

Michael Stick

Partner
617-248-4099 | mstick@choate.com

John Marshall Chambers

Principal
617-248-5212 | jchambers@choate.com

Sarah Camougis

Practice Group Leader
617-248-5025 | scamougis@choate.com

Brian Goldstein

Co-Chair of Business and Technology
617-248-5110 | bgoldstein@choate.com

Mark DeFeo

Partner
617-248-4902 | mdefeo@choate.com

Kevin Jarboe

Partner
617-248-2115 | kjarboe@choate.com

Louis Marette

Practice Group Leader - Tax
617-248-5091 | lmarette@choate.com

Daniel Riley

Partner
617-248-4754 | driley@choate.com

Kevin Tormey

Partner
617-248-4017 | ktormey@choate.com

Kevin Sarro

Senior Associate
617-248-5114 | ksarro@choate.com

Lee Feldman

Practice Group Leader
617-248-4053 | lfeldman@choate.com

John Pitfield

Co-Chair of Business and Technology
617-248-5093 | jpitfield@choate.com

Judith Fiorini

Partner
617-248-2105 | jfiorini@choate.com

Kimberley Kaplan-Gross

Partner
617-248-4051 | kkaplangross@choate.com

John Meltaus

Partner
617-248-5092 | jmeltaus@choate.com

Ed Saad

Partner
617-248-2113 | esaad@choate.com

Steve Meredith

Senior Counsel
617-248-5019 | smeredith@choate.com

Wealth Management Team

Jessica L. Lambert

Practice Group Leader
617-248-5223 | jlambert@choate.com

Charles A. Cheever

Co-Managing Partner
617-248-4027 | ccheever@choate.com

William A. Lowell

Senior Counsel
617-248-4085 | wlowell@choate.com

Brian W. Monnich

Practice Group Leader
617-248-5218 | bmonnich@choate.com

A. Silvana Giner

Partner
617-248-5216 | nginer@choate.com

Courtney N. Carr

Principal
617-248-5225 | ccarr@choate.com

Kristin T. Abati

Partner – Wealth Management
617-248-5266 | kabati@choate.com

Renat V. Lumpau

Partner
617-248-4040 | rlumpau@choate.com

Andree M. Saulnier

Of Counsel
617-248-5055 | asaulnier@choate.com