Carried Interest Tax Proposal: Potential Negative Impact to the Charitable Sector

In September, the House Ways and Means Committee marked up the Build Back Better Act, including a provision modifying how carried interest is treated under the tax code. While the Committee stopped short of taxing all carried interest as ordinary income, the restrictions included in the bill pose a direct threat to philanthropic givers and the charitable sector as a whole.

What did the Ways & Means Committee propose?

Section 138149 of the committee markup proposes to modify current section 1061 of the tax code to treat capital gain associated with holding a "applicable partnership interest" (essentially a partnership interest held by the taxpayer in connection with the performance of investment services) as long-term capital gain eligible for preferential rates only if the partner holds that interest for **at least 5 years**. The new rule will apply only to high income taxpayers (AGI $400,000 and above) and applicable partnership interests attributable to real property trades or business. Under current law, the holding period requirement is only 3 years, and that period would be maintained for non-high income taxpayers.

The provision would also amend section 1061(d) to provide that "If a taxpayer transfers any applicable partnership interest, gain shall be recognized notwithstanding any other provision of this subtitle." The intent is to prevent abuse by treating transactions that would normally be tax-free as taxable.

Background on section 1061(d)

The current iteration of section 1061(d) has been subject to criticism for its lack of clarity. That rule simply requires taxpayers who "transfer" an applicable partnership interest to a related party to include in income (as short-term capital gain) unrealized gain from capital assets held less than 3 years. The statute is not clear with respect to its application to nontaxable transfers, although the Treasury and IRS declined to apply to such transactions in final regulations released earlier this year.

With the objective of preventing abuse, the proposed statutory amendment to section 1061(d), would apply to both taxable and nontaxable transfers. In other words, if a taxpayer transferred an applicable partnership interest in any transaction (including one that would otherwise be a nontaxable transaction), that taxpayer would have to recognize and pay tax on the difference between the value of the applicable partnership interest and his adjusted basis in the same.

Impact on the charitable sector

Current law is clear that gifts, whether made to a charity or otherwise, generally do not result in gain recognition to the donor, even if the property has substantially appreciated in value. *See* Rev. Rul. 55-138, 1955-1 C.B. 223. That has been a long-standing principle in the tax code and is sound policy: a gratuitous transfer should not be treated as a realization event because the donor, having parted ways with the asset, has realized no income on which he can be taxed.

However, as currently drafted, Section 138149 would apply to gratuitous transfers of applicable partnership interests, including (but not limited to) gifts to charity. Thus, even where a donor divests himself entirely of an appreciated applicable partnership interest as part of a charitable donation, he could still be required to pay a substantial income tax. This will make transferring applicable partnership interests to charity basically unfeasible.

We believe Congress supports charity and does not intend to apply this tax on philanthropy. Therefore, we respectfully request that Congress draft a legislative fix if this proposal advances and protect charitable giving.