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TREASURY'S GREEN BOOK: IMPACT ON THE ASSET MANAGEMENT INDUSTRY

By Joe Pacello and Lei Wang

On May 28, 2021, the Treasury Department released its General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals, commonly referred to as the "Green Book." The Green Book summarizes the Biden Administration's tax proposals and changes contained in its fiscal year 2022 budget.

Most of the proposals would be effective for taxable years beginning after December 31, 2021, except as noted below. The following proposals are particularly relevant for managers of hedge funds and private equity funds.

EQUALIZATION OF CAPITAL GAIN AND ORDINARY INCOME TAX RATES

Effective for taxable years beginning after December 31, 2021, the top marginal individual income tax rate would increase from 37% to 39.6%. For taxable year 2022, the rate would apply to taxable income over $509,300 for married individuals filing jointly ($254,650 for married individuals filing separately), $481,000 for head of household filers, and $452,700 for single filers.

Long-term capital gains and qualified dividend income of individual taxpayers with adjusted gross income of more than $1 million would be taxed at ordinary income tax rates to the extent that the taxpayer's income exceeds $1 million ($500,000 for married individuals filing separately). If the proposal for raising the ordinary income tax rate to 39.6 % becomes law, then the maximum tax rate on capital gains and qualified dividend income would be 43.4% (39.6% plus net investment income tax of 3.8%). The proposed rate increase would apply to gains and qualified dividends required to be recognized after the date of announcement, which is understood to be April 28, 2021, the date of President Biden's first address to a joint session of Congress during which he introduced the American Families Plan.

INCOME FROM CARRIED INTERESTS TREATED AS ORDINARY INCOME

Under the Green Book proposal, a partner's share of income attributable to an "investment services partnership interest" as well as the gain on the sale of such interest would generally be taxable as ordinary income if the partner's income from all sources exceeds $400,000. Further, allocations of investment services partnership income would be treated as earnings from self-employment. This proposal is consistent with draft carried interest legislation introduced in the past as well as the Carried Interest Fairness Act of 2021 proposed on February 15, 2021. For taxpayers with taxable income of $400,000 or less, the Green Book suggests that Section 1061 would still apply.

However, the Green Book does not contain sufficient detail to determine whether gains under Section 1202 would be subject to the proposed rules.

SELF-EMPLOYMENT TAX VS. NET INVESTMENT INCOME TAX

Internal Revenue Code Section 1402(a)(13) currently provides that limited partners are not subject to self-employment tax on their distributive shares of partnership income. Further, as long as a limited partner is actively involved in a trade or business, they are also not subject to the net investment income tax. Due to the lack of a clear definition of "limited partner," taxpayers and the Internal Revenue Service have defined the term differently.

The Green Book proposes a 3.8% tax, in the form of either the net investment income tax or the Medicare tax under the Self-Employment Contributions Act (SECA), on all trade or business income of taxpayers with AGI in excess of $400,000. Therefore, if enacted, all active partners whether limited partners, LLC members, or S corporation shareholders would be subject to the 3.8% tax in one form or another. This provision would have a significant impact on certain management company structures. Note the net investment income tax would continue to apply to passive income such as capital gains and dividends allocated from investment partnerships, including carried interests.

Other Relevant Green Book Proposals

- The Biden administration plans to provide $80 billion in IRS funding over the next decade for increased audits of the wealthy and partnerships, along with upgraded technology.
- The Green Book proposes to impose a $500,000 per person limit ($1 million in the case of married individuals filing a joint return) on the amount of gain that can be deferred on like-kind exchanges of real property each year.
- The excess business loss limitation, which currently is set to expire in 2026, would be made permanent.
- Transfers of assets upon death or by gift would be treated as realization events. As a result, gains would be required to be recognized as if the underlying property had been sold, subject to a $1 million lifetime exclusion. Other exceptions would apply, such as spousal transfers at death and transfers to charity.
- The Green Book proposes a comprehensive financial account information reporting system applicable to the purchase or transfer of crypto assets. This reporting system would be effective beginning in 2023.
- A number of proposals in the Green Book would affect portfolio companies, such as raising the corporate tax rate, imposing a minimum tax on large corporations based on book earnings, and tax increases on multinational companies (including additional restrictions on interest expense deductions).

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CONTACT:

JOE PACELLO
Tax Partner
212-885-7375 / jpacello@bdo.com

LEI WANG
Tax Managing Director
203-905-6275 / Lei.wang@bdo.com

ANTHONY MOSCATO
Tax Partner, Asset Management Practice
212-885-7361 / amoscato@bdo.com

STEVE WINTER
Tax Partner
212-885-7270 / swinter@bdo.com

JONATHAN SCHMELTZ
Tax Partner, New York Asset Management Practice
212-885-8170 / jschmeltz@bdo.com

VERENDA GRAHAM
National Private Equity Tax Leader
629-224-4946 / vgraham@bdo.com

TODD SIMMENS
National Managing Partner of Tax Risk Management
732-491-4170 / tsimmens@bdo.com