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Proposed Legislation Would Subject Carried Interests to Ordinary Income Treatment

On August 5, 2021 Senate Finance Committee Chairman Ron Wyden and Senator Sheldon Whitehouse introduced proposed legislation (the "Ending the Carried Interest Loophole Act," or the "Proposal") that would substantially change the U.S. federal income tax treatment of partnership interests issued in exchange for services, commonly known as carried interests, and potentially other types of partnership interests as well. The Proposal would repeal Section 1061,[1] the "three-year carry rule" that was enacted as part of the 2017 tax reform legislation, and instead subject the holder of a carried interest to current inclusions of compensation income, taxable at ordinary income rates, in amounts that purport to approximate the value of a deemed interest-free loan from the partnership's other investors to the carried interest holder. The Proposal would be effective for taxable years of a taxpayer beginning after the date of enactment, provided that any applicable partnership's taxable year ends with or within the relevant taxpayer's year. For most impacted partnerships and partners, if the Proposal were passed anytime in 2021, the provisions would take effect for calendar year 2022.

Although the Proposal would likely be subject to revisions and clarifications before adoption as final legislation, the proposed rules raise, among other issues, potential phantom income and double taxation concerns for investment partnership sponsors, and uncertainties with respect to potential trade or business risks for non-U.S. persons and tax-exempt organizations that purchase carried interests as investors.

Key Takeaways

- Phantom Income and Double Taxation Risks. The Proposal would impute to a holder of carried interest each year ordinary income in an amount intended to approximate the interest that would accrue on a hypothetical loan equal to the capital required to generate an amount of profits allocable in respect of the carried interest (the "deemed compensation amount"). While the Proposal provides that the holder would simultaneously recognize a long-term capital loss equal to the deemed compensation amount, the holder's ability to utilize that capital loss will depend on the holder having at least that amount of capital gain (whether from the relevant partnership or another source).

  In short, the Proposal goes further than recharacterizing long-term capital gain from carried interest as ordinary income. It imputes ordinary income to a carried interest holder without regard to the amount, if any, of income or gain allocated in respect of the carried interest and offsets partnership income or gain that is or will be also allocated to the holder in respect of the carried interest only to the extent those allocations consist of capital gain. Sponsors of funds not expected to generate capital gains well in excess of the deemed compensation amount may consider structuring their incentive compensation as a fee instead of a profits interest, subject to the rules under Section 409A, Section 457A and Section 212, as applicable. But replicating a typical carried-interest economic deal as a fee (without being subject to punitive excise taxes) can be challenging under these rules.

- Application to Corporations and Accrual Basis Taxpayers. The Proposal does not carve out from its application either corporations, which are taxed on capital gains and ordinary income at the same rate, or accrual basis taxpayers, who are generally not treated as deferring compensation income under normative tax principles.

- Application Triggered by Most Partnership Loans. Loans from the partnership or other partners (or their related parties) appear to trigger application of the "deemed loan" rule to a partner incurring the debt without regard to

[1] Section references are to the Internal Revenue Code of 1986, as amended.

whether the partner receives the partnership interest in connection with the performance of services or is in an investment or fund raising business.

- Uncertainty for Complex Carry Arrangements. The Proposal is drafted assuming relatively simple carried interest structures, and does not adjust the hypothetical loan amount to more accurately reflect the economics of common alternatives, including deal-specific carry, premium carry and investor protections (such as hurdles and preferred returns). By using the maximum possible percentage of profit to calculate a partner's "applicable percentage" (effectively the percentage of partnership capital constituting the hypothetical loan, as described below), varied profits interest structures could result in punitive taxation. In addition, the "specified rate" (effectively the hypothetical interest rate on the hypothetical loan, as described below) is the same for all types of investment strategies and asset classes, and does not take into account that some investment strategies produce lower returns by reason of their lower risk.

- Potential Impact on State and Local Taxation. The state and local tax consequence of changing the federal tax treatment of carried interest as proposed is unclear. For example, sponsors located in New York City could see an increase in unincorporated business tax liability as a result of the "deemed compensation amount."

- Special Concerns for Non-U.S. and Tax-Exempt Carry Recipients and Investors in Fund Sponsors. The Proposal does not confirm whether the deemed compensation amount would be treated as "effectively connected income" in the hands of non-U.S. persons or "unrelated business taxable income" in the hands of tax-exempt organizations. This could increase the use of blocker corporations to hold interests in fund sponsors and alter the economics of investments in carried interest streams.

Detailed Description of the Proposed Legislation

Expanded Definition of API

Like Section 1061, the Proposal would apply to holders of "applicable partnership interests" ("APIs") – generally partnership interests that are directly or indirectly transferred or held in connection with the performance of services in any "applicable trade or business" ("ATB"), which generally covers the typical activities of fund sponsors. The Proposal however modifies the definition of API and ATB in several respects:

- Whereas an API under Section 1061 entailed the provision of "substantial" services to the partnership by the taxpayer or any other "related" person, the Proposal's definition of API includes neither such qualifier.

- Interests in partnerships, as well as interests in financial instruments based on those interests can be APIs. Treasury would be delegated authority to issue regulations to include interests held in other entities (e.g., corporations) or other arrangements more broadly in the definition of API.

- API generally includes a partnership interest to the extent directly or indirectly financed with debt from the partnership or other partners (or their related persons), regardless of whether received in connection with the performance of services in an ATB, unless the debt that is fully recourse to the borrower or fully secured by the borrower's assets and bears interest at a rate not less than the rate used to calculate the deemed compensation amount.

- The Proposal revises Section 1061's definition of ATB, including by expanding the definition of "securities" to include any interest in a partnership or trust, regardless of whether widely held or publicly traded, and carving out from the definition of "commodities" any commodities held "in connection with the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities."

The Deemed Compensation Amount and Related Provisions

The Proposal would require a taxpayer to include currently as ordinary income a deemed compensation amount for each taxable year of a partnership that ends within a taxable year of the taxpayer during any part of which the taxpayer held an API in that partnership, and deem the API holder to incur a long-term capital loss equal to the amount of each such inclusion. The press release for the Proposal explains that the deemed compensation amount is intended to approximate the value of an interest-free loan from the partnership's investors to the API holder in the amount of the investors' capital "used to invest for the [API holder's] own account."

- The deemed compensation amount with respect to a taxable year of a partnership equals the product of (x) a "specified rate" of interest for the calendar year in which such taxable year begins, which is the sum of a statutory rate determined by the Treasury (e.g., 1.75% for 2021) plus 9 percentage points *multiplied by* (y) the excess of (i) the product of the "applicable percentage" *multiplied* by the "weighted average" of the aggregate "invested capital" of all partners in the partnership on each "measurement date" during such taxable year, over (ii) the weighted average of the amount of the API holder's invested capital in the partnership on each such measurement date.

    - The "applicable percentage" is "the highest percentage of profits of the partnership which could be allocated to such interest (consistent with the partnership agreement and determined as if all performance targets with respect to such interest had been met)." Profit "catch-up" allocation provisions common in many partnership agreements could arguably cause the applicable percentage to be 100% in certain years. The detailed summary of the Proposal suggests that regulations will be issued to modify the calculation of the deemed compensation amount in these circumstances.

    - "Invested capital" for this purpose is generally equal to (i) capital contributions to the partnership and income allocations, minus (ii) distributions by the partnership and loss allocations, reduced by the amount of any "applicable loan" to the API holder. Deemed contributions and distributions under Section 752 and income inclusions under Section 704(c) with respect to contributed capital are ignored in this calculation.

    - A "measurement date" occurs on each of the last day of the partnership's taxable year and each day on which the Treasury Regulations allow the partnership to revalue its property for the purpose of determining capital accounts.

- The Proposal would deem the API holder to incur a long-term capital loss equal to (and in the same year of) the deemed compensation amount for the stated purposes of mitigating the double taxation that would otherwise result from allocations of income and gain to the API holder. While the Proposal does nothing to allow this capital loss to be used to offset short-term capital gains or ordinary items of income allocated to the API holder in respect of its API, it also does not limit the use of the capital loss to offset capital gain recognized from other sources.

- Upon a sale of an API within 10 years of the later of the API holder's acquisition of the API and the last date on which there was an increase in the API holder's applicable percentage of the aggregate invested capital, the API holder would be required to accelerate the inclusion of a deemed compensation amount based on the portion of the API that was sold and the amount that would have been includible as deemed compensation amounts over the remainder of that 10-year period with respect to the sold API or portion thereof.

- The Proposal would deem the API holder to make a Section 83(b) election in respect of its API unless the API holder affirmatively opts out.

- Partnerships would be required to report the amount of an API holder's deemed compensation amount on the API holder's Schedule K-1.

Example

The following example was provided in the press release that accompanied a detailed summary released by Senators Wyden and Whitehouse at the time of the draft legislation:

> If the fund manager receives a 20 percent carried interest in exchange for managing investors' capital of $100 million, and the prescribed interest rate for the tax year is 14 percent, the fund manager would pay the top ordinary income tax rate of 40.8 percent tax on $2.8 million in deemed compensation.

Effective Date

The Proposal would be effective for taxable years of a taxpayer beginning after the date of enactment, provided that any applicable partnership's taxable year ends with or within the relevant taxpayer's year. For most partnerships and partners, if the Proposal were enacted anytime in 2021, the provisions would take effect for calendar year 2022.

Additional Uncertainties and Areas for Clarification

- The full extent of the intended scope of the definition of API under the Proposal remains unclear. The Proposal grants Treasury broad authority to expand its application through regulatory guidance.

- The details of various calculations required under the proposed rules, including the "weighted average" construct in the "deemed compensation amount" formula, remain unclear. Further changes and clarifications to the statutory text and subsequent regulatory guidance could therefore significantly affect the scope and application of the rules.