Update on Carried Interest Legislation

By Bradford D. Whitehurst of Bingham McCutchen LLP

Summary

Congress is currently considering legislation designed to tax partnership capital gains allocated to managers of hedge funds and private equity partnerships at ordinary income rates. As drafted, however, this "carried interest" legislation would affect members of many existing partnerships, including small businesses, family partnerships, corporate joint ventures and other partnerships that are not commonly thought to be the subject of the legislation.

This legislation is not limited to holders of "carried interests." Nor is it limited to allocations of capital gain income. It applies to corporations, which pay the same tax rate on capital gains as on ordinary income. Taxpayers caught up in the legislation would be taxed at higher rates on their shares of partnership capital gains, would be unable to deduct all or a portion of their share of partnership losses, would be denied the use of common nonrecognition provisions (including tax-free partnership distributions), and could be subject to the 2.9% hospital insurance ("HI") tax on a portion of their partnership income.

The legislation applies to any partner who renders substantial services to a partnership that owns "specified assets," including rental real estate, stock and securities, and interests in other partnerships. Thus, it covers most tiered partnership arrangements. Extremely broad related party rules greatly extend the proposal's reach.

The proposal legislation contains two narrow exceptions. One is for partnership structures whose allocations are "straight up", including allocations in all lower tier partnerships. A second is for allocations with respect to "qualified capital" of the service provider, where unrelated partners who are not service providers receive the same allocations. This exception is unavailable for family partnerships (because they have no unrelated partners) and many real estate partnerships (qualified capital is reduced by losses; partners with negative tax capital accounts have no qualified capital).

The following contains a summary of the proposed legislation and several examples illustrating its unexpected consequences. Particular attention should be given to Examples 1 (family real estate partnership, all equal partners: losses denied, capital gains benefits curtailed, HI tax imposed), 2 (same, transfer of interest in divorce taxed), 3 (straight-up family operating business partnership, tiered structure: operating losses not deductible and converted to capital losses on disposition of business) and 5 (publicly-traded corporation, internal partnership: losses not deductible, gain triggered by "tax free" merger).

The legislation has not been enacted, and may be modified prior to passage. Moreover, the Treasury Department may ameliorate the impact of the rules through regulations. As currently drafted, however, the potential adverse impact of this proposal cannot be overstated.

Status of Carried Interest Legislation in Congress

The House of Representatives passed carried interest legislation on May 28, 2010, as part of the American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213). The Senate has considered several modified versions of the carried interest legislation proposed as part of the larger House bill. The last was circulated by Senator Baucus in September of 2010. Enactment of carried interest legislation in 2011 as part of an overhaul of the tax code, or as a revenue offset to other legislation, is uncertain. Any carried interest legislation would have to be passed again by the House of Representatives. The Joint Committee on Taxation's revenue estimate for an earlier version of the carried interest legislation was approximately $14 billion.

Summary of Legislation

In general, the legislation defines certain interests in a partnership as "investment services partnerships interests" ("ISPIs") and subjects such interests to special treatment under what would be a new section 710 of the Internal Revenue Code. An ISPI is defined as any interest in a partnership which is held (directly or indirectly) by any person if it was reasonably expected (at the time that such person acquired such interest) that such person (or any person related to such person) would provide (directly or, to the extent provided by the Secretary, indirectly) a substantial quantity of certain services with respect to assets held (directly or indirectly) by the partnership. Those certain services are (1) advising as to the advisability of investing in, purchasing, or selling any specified asset, (2) managing, acquiring, or disposing of any specified asset, (3) arranging financing with respect to acquiring specified assets, and (4) any activity in support of any of the foregoing services. For this purpose, "specified assets" mean securities, real estate held for rental or investment, interests in other partnerships, commodities, or options or derivative contracts with respect to any of the foregoing. A partnership interest that is not an ISPI at the time of issuance may become an ISPI if the partner holding the interest (or any person related to that partner) begins providing the services described above with respect to specified assets held by the partnership.

<u>Ordinary Income and Loss Disallowance</u>. Subject to the applicable percentage rules described below, any net income with respect to an ISPI for any partnership taxable year will be treated as ordinary income. Any net loss with respect to the ISPI will be allowed as an ordinary loss, but only to the extent the loss does not exceed the excess (if any) of (1) the aggregate net income with respect to the ISPI for all prior partnership taxable years to which the new section 710 applied, over (2) the aggregate net loss with respect to the ISPI not disallowed for all prior partnership taxable years for which the new section 710 applied. Any net loss that is not allowed will be carried forward to the next partnership taxable year.

<u>Dispositions and Gain Recognition</u>. Subject to the applicable percentage rules described below, any gain on the disposition of an ISPI will be taxed as ordinary income. This gain is taxable even if the transaction would otherwise qualify for nonrecognition under other provisions of the Internal Revenue Code (such as a distribution of an ISPI in liquidation of a partnership or contribution of an ISPI to a corporation). Any loss on the disposition of an ISPI will be treated as an ordinary loss, but only to the extent of the excess (if any) of (1) the aggregate net income with respect to such interest for all partnership taxable years to which section 710 applied, over (2) the aggregate net loss with respect to such interest allowed for all partnership taxable years to which new section 710 applied.

There is a narrow exception from the gain recognition requirement. A taxpayer may avoid recognizing gain upon the disposition of an ISPI only if (1) the disposition is part of a contribution of the interest to a partnership in exchange for an interest in such partnership, (2) the disposition is in connection with a partnership merger or division, or (3) the disposition is deemed to occur pursuant to a termination of the partnership under section 708(b)(1)(B). To qualify for this exception, the taxpayer must make an irrevocable election to treat the partnership interest received in the exchange as an ISPI and must agree to comply with reporting and recordkeeping requirements imposed by the Internal Revenue Service.

Indirect Dispositions of Investment Services Partnership Interests. Any ISPI held by a partnership is treated as an inventory item under section 751. Thus, if a partner sells an interest in an upper-tier partnership that holds an ISPI in a lower-tier partnership, the gain realized by the selling partner will be treated as ordinary income to the extent such gain is attributable to the gain the upper-tier partnership would have realized if it had disposed of its ISPI in the lower-tier partnership.

Qualified Capital. To the extent the holder of an ISPI has qualified capital, all allocations attributable to such qualified capital will not be taken into account if (1) the allocations of items to the qualified capital interest of the service partner are made by the partnership in the same manner as allocations are made to other qualified capital interests held by unrelated partners who do not provide any of the proscribed services with respect to specified assets described above, and (2) the allocations made to the other interests are significant compared to the allocations made to the qualified capital portion of the ISPIs held by service providers. The qualified capital of a partner is generally equal to the sum of the fair market value of any money or other property contributed to the partnership by the partner, any amounts included in gross income under section 83 with respect to the transfer of such interest, and the partner's distributive share of any net income received with respect to the interest, minus distributions and the partner's distributive share of any net losses received with respect to the interest, for all taxable years, including before the effective date of the legislation.

Applicable Percentage. For individuals only, the treatment of income or gain attributable to an ISPI as ordinary income is limited to the "applicable percentage" of such income or gain. Under the House passed legislation, the applicable percentage is 50% before January 1, 2013, and 75% thereafter. Under the latest Senate version, the applicable percentage is 75% beginning on the effective date (January 1, 2011), but has a reduced applicable percentage of 50% for (1) income from the disposition of assets held at least 5 years and (2) income from the disposition of an ISPI that has been held for at least 5 years to the extent the income or gain is attributable to assets that have been held for at least 5 years. For this purpose, the holding period of goodwill and other intangibles of an investment services partnership will be treated as being not less than the partner's holding period in the partnership interest.

"Straight Up" Exception. The most recent proposals by Senator Baucus contain a limited exception for partnerships with pro rata allocations based on capital. The exception provides that the term ISPI does not include any interest in a partnership if all distributions and all allocations of the partnership, and any other partnership in which the partnership directly or indirectly holds an interest, are made pro rata on the basis of the capital contributions of each partner which constitute qualified capital interests. This exception is not included in the provision passed by the House of Representatives.

Self-Employment Tax. The carried interest legislation also provides that in the case of any individual engaged in the trade or business of providing the services proscribed in the carried interest legislation with respect to any entity, any amount treated as ordinary income or ordinary loss of such individual under section 710 with respect to such entity will be taken into account in determining the net earnings from self-employment of such individual. In 2010, the tax on self-employment income consisted of a 12.4% social security tax on the first $106,000 of the individual's combined wages, tips and net earnings, and a 2.9% health insurance tax on the individual's entire self-employment income.

Implications for Partnerships

The carried interest legislation as drafted potentially affects interest holders in many existing partnerships, not just managers of private equity funds, hedge funds, venture capital funds, and real estate investment partnerships. Any partnership where a partner provides management services with respect to specified assets is potentially subject to the legislation. In particular, the definition of specified assets includes partnership interests and, according to the Joint Committee on Taxation's explanation of H.R. 4213, any services provided by a partner with respect to the assets of a subsidiary partnership are treated as services with respect to specified assets regardless of whether the subsidiary partnership actually holds specified assets. Therefore, the legislation would apply to tiered partnerships structures and any partners that provide services to either the upper-tier or lower-tier partnership (and persons related to such partners).

The legislation also adversely affects closely held partnerships that do not have unrelated partners who are not service providers. This impact is especially broad because the proposed legislation uses a broad definition of related persons for purposes of determining whether another partner is related to a service provider. This broad definition of related persons means that many partnerships will be treated as not having any partners that are unrelated to service providers and, as a consequence, no partner will be able to qualify for the exception for qualified capital. The partners of such partnerships are therefore potentially liable to recharacterization of income or gain, disallowance of losses, or acceleration of gain notwithstanding the fact that they have contributed capital to the partnership. Although the Senate proposal contains a limited exception for "straight up" partnerships, many partnerships are not entirely "straight up."

The following examples illustrate situations where the rules described above may produce unexpected tax consequences:

Example 1: Family Real Estate Partnership

Facts: Husband ("H") and Wife ("W") and their three children are each 20% partners in Family Limited Partnership ("FLP"). H and W contributed an equal amount of cash for their interest, and made gifts of FLP interests to their children. FLP owns various rental real estate investments. One of these investments consists of a partnership interest in a joint venture with a local developer, who received a disproportionate share of the profits in exchange for putting the deal together. H rendered substantial services to FLP during the 1990's as the portfolio was put together. None of FLPs' partners have rendered significant services to FLP in the last ten years.

Result: All interests in FLP are ISPIs. Assuming all investments are at least five years old, 50% of any gains from property sales will be taxed as ordinary income. 50% of any losses from dispositions and 75% of any net operating losses will be disallowed to the extent they exceed the gains or net income, respectively, taxed as ordinary income in a prior year under new section 710. Any disallowed disposition loss or disallowed net operating loss will be required to be carried forward.

Analysis: FLP owns rental real estate, which is a "specified asset." H rendered substantial services to FLP, rendering his interest an ISPI. W and the three children are related to H, so their interests are ISPIs. Since there are no unrelated partners, the exception for qualified capital is unavailable. Since FLP owns an interest in a partnership with a local developer which contains disproportionate allocations, the exception for "straight up" partnerships is unavailable.

Example 2: Family Real Estate Partnership

Facts: Assume the same facts as in Example 1. H and W now get divorced. Incident to the divorce, H transfers his FLP interest to W. W's daughter contributes her interest in FLP to a newly formed S corporation that she owns with her husband and children (having heard about the carried interest rules, she decided not to use a partnership).

Results: H is taxed on 50% of the gain inherent in his interest in FLP at ordinary rates. Daughter is similarly taxed on the transfer of her FLP interest to her family S corporation.

Analysis: The gain recognition rules of the legislation overrides most nonrecognition provisions of the Internal Revenue Code, including sections 1042 (transfers incident to divorce) and 351 (contributions to controlled corporations). The transferor is required to recognize the applicable percentage of any realized gain (in this case 50% assuming that all of the investments of FLP were held for at least five years prior to the date of transfer).

Example 3: Family Operating Business

Facts: H and W are equal owners of Car Dealership LP ("CDLP"), to which each contributed $1 million and for which each works full time. In order to expand, CDLP entered into a joint venture ("JV") with H's best friend ("F") to start a car dealership across town. CDLP and F contributed equal cash to JV. In order to raise cash for their business, the partnership issued nonparticipating preferred interests to investors. The preferred interest holders receive a stated return and are not entitled to participate in the profits of the partnership beyond the stated return. Profits in excess of the preferred return are shared equally by CDLP and F. Prior to 2011, CDLP distributes its profits each year. The economy sours and CDLP loses $1.0 million in 2011. CDLP makes no income in 2012. H and W sell their interests in CDLP at the end of 2012 for $1 million total. They retire and have no capital gains in 2012 or thereafter.

Result: Only $250,000 of CDLP's loss is deductible in 2011. H and W have a capital loss of $750,000 in 2012. Unless they have capital gains from other sources, they can deduct only $3,000 of this loss per year. When they die, the unused loss dies with them.

Analysis: CDLP's interest in JV is a specified asset. Since H renders substantial services with respect to JV, H's interest in CDLP is an ISPI, as is W's (since they are related). CDLP has no unrelated partners, so the qualified capital exception is unavailable.

Because the allocations to the preferred investors differ from those to CDLP and F, the "straight up" exception is not available. Accordingly, 75% of CDLP's 2011 operating loss is disallowed and carried forward and may only be used against 75% of CDLP's future operating income. The special 50% rate for 5-year assets is unavailable to H and W because their losses arose from operations rather than from a decline in asset value. The basis of their interests in CDLP is reduced by the $250,000 allowable loss, to $1,750,000. The sale of CDLP interest at the end of 2012 for $1 million generates a long term capital loss of $750,000, which is deductible only to the extent of capital gains plus $3,000 per year. Thus, H and W will not be able to utilize their $750,000 economic loss unless they generate substantial capital gains in the future. Unused capital loss carryforwards expire on death.

Example 4: Tax Loss Partnership ("TLP")

Facts: Developer LLC ("D") develops office buildings. D formed Office Building LLC ("OB LLC") in 2007 in a highly leveraged transaction and syndicated interests. D retained a "promote" interest. Investor ("I") purchased a unit in OB LLC for $100,000. I has taken losses of $250,000 as of year end 2010 and has a negative tax capital account of ($150,000). I's son ("S") recently took a low level job with D, receiving a 0.01% interest in D as part of his compensation package. In 2011, the original bridge financing on the office building held by OB LLC cannot be rolled over, and the lenders foreclose on the office building.

Result: I has a gain of $150,000, 75% of which is ordinary income and subject to self-employment tax.

Analysis: D has an interest in OB LLC and also provided substantial services with respect to the real estate held by OB LLC for rent. Therefore, D's interest is an ISPI. S is related to D under section 267(e)(1)(B)(i). I is treated as owning S's interest in D, making I related to D. Even though I's interest is the same as those held by other unrelated investors, all of whom contributed cash to OB LLC, I's qualified capital amount (originally $100,000) is reduced by tax losses. I thus has negative qualified capital, and therefore gets no relief under the qualified capital exception.

Moreover, all the partners of OBLLC are treated as related to D under section 267(e)(1)(C), and thus all interests in OBLLC are ISPIs.

Comment: The results in this example are attributable to the unusually broad definition of related party used in the carried interest legislation. Forthcoming Treasury regulations would need to grant relief under both the qualified capital provision and the related party rules to achieve a sensible outcome.

Example 5: Corporate Joint Venture

Facts: XYZ Corp. ("XYZ") is a large publicly traded corporation engaged in the business of making and selling widgets. The original widget business started as an equal joint venture ("JV") with W Co. XYZ bought W Co.'s interest in JV for cash several years ago. In order to preserve the state law legal entity, XYZ purchased W Co.'s interest in JV through a wholly-owned subsidiary. To facilitate distribution of its widgets, JV has entered into numerous joint ventures with third parties that involve complex sharing arrangements. In 2011, JV incurs substantial losses. In 2012, XYZ mergers into Big Co.

Results: XYZ cannot deduct any of JV's 2011 losses. The entire gain in the widget business is taxable to XYZ at the time of the merger.

Analysis: JV's interests in the third party joint ventures are specified assets. XYZ renders substantial services to JV (including the subsidiary joint ventures). All of XYZ's interests in JV are ISPIs. There are no unrelated partners in JV that are not service providers, so the qualified capital exception is unavailable. The lower tier partnerships have complex sharing arrangements so the exception for "straight up" partnerships is also unavailable. The 50% and 75% applicable percentage "cutbacks" are available only to individuals. Thus 100% of the 2011 loss is disallowed, and the appreciation in XYZ's interest in JV is fully taxable in the 2012 merger, even if the merger otherwise qualifies as a tax-free reorganization.

Bradford D. Whitehurst, bradford.whitehurst@bingham.com

Brad Whitehurst's practice focuses on tax planning. He has advised real estate investment trusts, partnerships, limited liability companies, private equity and venture capital funds, and tax-exempt organizations regarding tax matters.

Full Bio

Bingham McCutchen LLP

About Bingham's Tax Practice

Bingham offers a broad range of market-leading practices focused on global financial services firms and Fortune 100 companies. We have 1,100 lawyers in 13 locations in the U.S., Europe and Asia. The Bingham tax group is a destination for many sophisticated businesses. Clients come to us when they face complex or particularly significant tax planning or controversy issues. They continue to rely on us as tax counsel because they appreciate the depth of our technical acumen, the breadth of our experience, the currency of our market knowledge, and our commitment to help them responsibly and legally minimize tax liability without exposing them to undue risk.

What makes us different? We offer a balanced perspective, as our tax planners are integral to our controversy practice and vice versa. We have extraordinary technical understanding in a range of critical areas. In certain areas, we literally wrote the book. Our experience is both deep and broad. For decades, we have represented sophisticated and demanding clients across a variety of industries and transactions. We achieve results. Clients know that our added value shows in the bottom line.