

Tax Insights

from Grant Thornton's National Tax Office

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House passes carried (profits) interest legislation

On Dec. 9, 2009, the U.S. House of Representatives passed legislation containing a carried interest provision as a revenue offset to a number of expiring tax provisions, including the research credit. The carried interest provision generally would cause income attributable to carried (or profits) interests to be taxable at ordinary income rates (as opposed to capital gains rates) and subject to self-employment taxes in the case of income reported by an individual. The legislation will now move to the Senate for consideration. Although the carried interest provision is likely to face strong opposition in the Senate, there is bipartisan support for the extension of the expiring provisions, and it is not clear whether an alternative revenue offset is available.

Background

The term “carried interest” is synonymous with “profits interest” (profits interests are sometimes referred to as carried interests). Under current law, when a partnership grants a profits interest (as contrasted with a capital interest) in exchange for services, the grant of profits interest is generally not a taxable event for the partnership or for the profits interest holder. Instead, the profits interest holders generally take their share of partnership profits into income as the profits are reported to them and, subject to certain exceptions, recognize capital (versus ordinary) gain upon a taxable disposition of the partnership interest. Moreover, the profits interest holders’ distributive share of partnership income generally retains the character the income has at the partnership level (i.e., if the partnership recognizes capital gain, then the profits interest holders would likewise recognize capital gain on the distributive share of the partnership’s gain).

Under current law, the recipient of a profits interest in a partnership in exchange for services may make a Section 83(b) election within 30 days of receipt of the profits interest. A Section 83(b) election allows an employee or service provider to recognize any income from the receipt of property (including a partnership or other equity interest) in the taxable year of the transfer even though the property is substantially non-vested (meaning it would normally not be recognized until it is no longer subject to a substantial risk of forfeiture). Even if no Section 83(b) election is made, current law will treat the partnership and the profits interest holder as if a Section 83(b) election had been made if certain conditions are satisfied. When a Section 83(b) election is made (or the conditions are

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satisfied and the partnership and the profits interest holder are treated as if a Section 83(b) election had been made), neither the partnership nor the profits interest holder has a taxable event because the fair market value of the profits interest (i.e., the measure of taxability and deduction to the profits interest holder and the partnership, respectively) is measured by the amount the profits interests holder would receive if the partnership were to liquidate immediately after issuing the profits interest. If the interest is a true profits interest (as opposed to a capital interest), then the profits interest holder will always be entitled to receive zero immediately after receiving the profits interest. Thus, the service provider's taxable amount (and the partnership's offsetting deduction amount) on receipt (issuance) of a profits interest is always zero.

Proposed changes

Section 83 changes

The carried interest provision generally follows current law regarding the application of Section 83 to profits interests. In the case of a transfer after the date of enactment of any interest in a partnership in connection with the provision of services to, or for the benefit of, the partnership, the provision provides for a determination of the fair market value of the partnership interest and provides that the recipient of the partnership interest would be deemed to have made a Section 83(b) election unless the person affirmatively elects otherwise. Thus, absent such an election, a transferee of a partnership interest for services would be required to include in income for the taxable year of the transfer the fair market value (if any) of the partnership interest. As discussed above, if the interest is a profits interest, then this amount will always be zero.

Under the provision, the fair market value of the partnership would generally be its liquidation value for purposes of Section 83; i.e., the fair market value is deemed to be the amount the partner would receive if, at the time of transfer of the partnership interest, the partnership had sold all its assets at fair market value and distributed the proceeds (reduced by the partnership liabilities) to the partners in liquidation of the partnership.

Recharacterization of income

The provision would generally treat "net income" from an "investment services partnership" as ordinary income (regardless of whether such income would otherwise be treated as capital gain, dividend income or any other type of income in the hands of the partner) except to the extent it is attributable to the partner's qualified capital interest. Such income would be taxed at ordinary income rates and subject to self-employment tax.

Net income means, with respect to an investment services partnership interest, the excess of (1) all items of income and gain taken into account by the partner with respect to the partnership interest for the partnership taxable year, over (2) all items of deduction and loss taken into account by the partner with respect to the partnership interest for the partnership taxable year. All items of income, gain, deduction and loss taken into account in computing net income (or net loss) would be treated as ordinary income (or ordinary

loss). Any amount treated as ordinary income or ordinary loss from investment services would be included in determining net income from self-employment.

An investment services partnership would be a partnership held (directly or indirectly) by any person if it was reasonably expected (at the time the person acquired the partnership interest) that the person (or any related person) would provide, or already has provided, (directly or indirectly) a substantial quantity of certain services with respect to assets held (directly or indirectly) by the partnership. These services are:

- advising as to the advisability of investing in, purchasing or selling specified assets;
- managing, acquiring or disposing of any specified asset;
- arranging financing with respect to acquiring specified assets; and
- any activity in support of any of the foregoing services.

Activities in support of these services are intended to include supervising or assisting others who perform the services.

For this purpose, specified assets would mean securities (as defined in Section 475(c)(2) without regard to the last sentence), real estate held for rental or investment, interests in partnerships, commodities (as defined in Section 475(e)(2)), or options or derivative contracts with respect to such securities, real estate, partnership interests or commodities.

A security for this purpose means any:

- share of corporate stock;
- partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust;
- note, bond, debenture or other evidence of indebtedness;
- interest rate, currency or equity notional principal contract;
- interest in or derivative financial instrument in any such security or any currency (regardless of whether Section 1256 applies to the contract); and
- position that is not such a security and is a hedge with respect to such a security and is clearly identified.

A partnership interest would include any partnership interest that is not otherwise treated as a security for purposes of the provision (e.g., an interest in a partnership that is not widely held or publicly traded). For purposes of the provision, assets held (directly or indirectly) by the partnership would be considered to include assets held through any other entity, including a corporation.

Losses

Consistent with the rule recharacterizing net income from an investment services partnership as ordinary income, the provision also would provide that net loss with respect to such a partnership interest (to the extent not disallowed) generally is treated as ordinary. Net loss means, with respect to an investment services partnership, the excess of (1) all items of deduction and loss taken into account by the partner with respect to the

partnership interest for the partnership taxable year, over (2) all items of income and gain taken into account by the partner with respect to the partnership interest for the partnership taxable year. The net loss would be allowed for a partnership taxable year, however, only to the extent that the loss does not exceed the excess of (1) aggregate net income with respect to the partnership interest for prior partnership taxable years, over (2) the aggregate net loss with respect to the partnership interest not disallowed for prior partnership years. Any net loss not allowed for the partnership taxable year would be carried forward to the next partnership taxable year.

Contrary to the current basis adjustment rules relating to a partner's distributive share of partnership losses and deductions, the provision provides that no adjustment would be made to the basis of an investment services partnership interest on account of a net loss that is not allowed for the partnership taxable year. When any such net loss that is carried forward is allowed in a subsequent year, the adjustment would be made to the basis of the partnership interest.

Finally, a net loss from an investment services partnership (to the extent allowed in computing taxable income) would be taken into account for purposes of determining self-employment tax for the taxable year. However, to the extent a loss is disallowed under this provision for a taxable year, that loss would not reduce the taxpayer's net earnings from self-employment for that taxable year, but would be taken into account in the carryover year for which it is allowed in determining the amount of ordinary income under the net loss provision.

Capital interest exception

Under the provision, the recharacterization rule described above would not operate for items of income, gain, loss and deduction that are allocated to the portion of an investment services partnership interest that is a qualified capital interest, provided other requirements are met.

A qualified capital interest would be the amount of a partner's interest in partnership capital attributable to:

- the fair market value of money or other property contributed by the partner to the partnership in exchange for the partnership interest (determined without regard to the deemed contribution rules of Section 752(a) or any other deemed contribution),
- the amount included in the partner's gross income under Section 83 with respect to the transfer of the partnership interest by the partnership for services, and
- the partner's distributive share of cumulative net income and gain of the partnership included in the partner's income, if any, that has not been distributed by the partnership in taxable years to which the provision applies.

The qualified capital interest would be reduced by partnership distributions to the partner in taxable years to which the provision applies, and by the partner's share of partnership

losses. In the case of a transfer of an investment services partnership interest in a fully taxable transaction, the transferee partner would inherit the amount of the qualified capital interest of the transferor partner.

The requirements to avoid recharacterization of items of income, gain, loss and deduction that are attributable to a qualified capital interest would be met if (1) items are allocated to the service providing partner's qualified capital interest in the same manner as the items are allocated to other qualified capital interests of partners that do not provide any of the described services and that are not related to the service-providing partner, and (2) the allocations are made to the qualified capital interests of unrelated non-service providing partners are significant compared to the allocations made to the service providing partner's qualified capital interest.

For purposes of the exception for qualified capital interests, an investment services partnership interest would not be treated as acquired by contribution of capital by a service-providing partner to the extent of any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or by a person related to that other partner or the partnership).

In addition, for this purpose, any loan or other advance to the partnership made or guaranteed directly or indirectly by a partner not providing services to the partnership would be treated as the capital interest of that partner for purposes of determining the amount of the service-providing partner's qualified capital interest (but not, however, for purposes of comparing allocations to the service provider's qualified capital interest to qualified capital interests of unrelated partners who are not service providers). Income and loss treated as allocable to capital interests of partners would be adjusted accordingly.

Dispositions

On the disposition of an investment services partnership interest, the provision would treat gain as ordinary income, notwithstanding the present-law rule that gain or loss from the disposition of a partnership interest is generally considered as capital gain or loss. Gain on the disposition of an investment services partnership interest would be recognized notwithstanding any other income tax provision, such as nonrecognition or deferral rules. Loss on the disposition of an investment services partnership would be treated as ordinary loss, but only to the extent of the amount by which aggregate net income previously treated as ordinary exceeded aggregate net loss previously reported as ordinary under the provision. The amount of net loss that otherwise (but for the rule providing for no basis reduction discussed above) would have reduced basis of the investment services partnership interest would be disregarded for purposes of the provision, in the event of any disposition of the interest.

For a disposition of an investment services partnership interest that includes a qualified capital interest, a proportionate amount of the gain or loss on disposition would not be subject to recharacterization as ordinary. The proportionate amount of the gain or loss

assigned to the qualified capital interest would be determined generally by the ratio of the gain or loss on liquidation of the partner's qualified capital interest to the gain or loss on liquidation of the partner's entire investment services partnership interest (as if the liquidation occurred immediately before the disposition).

Distributions

On the distribution of property by a partnership to a partner with respect to an investment services partnership interest, the provision provides generally that the partner recognizes ordinary income to the extent of any appreciation in the property. Specifically, the provision provides that the excess of the fair market value of the property at the time of the distribution over the adjusted basis of the distributed property in the hands of the partnership would be included in income by the partner; it would be considered ordinary income by reason of the general rule of the provision. This amount would not be included to the extent it is otherwise taken into account in computing the taxable income of the partnership, e.g., by reason of Section 751(b).

To the extent the fair market value of the property (which is treated as money) exceeds the partner's adjusted basis in its partnership interest, the partner would have ordinary income. The basis of the distributed property would be its fair market value at the time of the distribution. The adjusted basis of the distributee partner's interest in the partnership would be reduced (but not below zero) by the amount of the money upon the distribution.

So that the partners' shares of the basis of partnership property would not be affected by the property distribution, the present-law rule providing for an adjustment to the basis of the partnership's property in the event of a Section 754 election or a substantial basis reduction would be applied without regard to the income inclusion rule for property distributions with respect to an investment services partnership interest.

Other entities

The provision would also recharacterize as ordinary income the income or gain with respect to certain other interests, including interests in entities that are held by a person who performs, directly or indirectly, investment management services for the entity. This rule would apply if:

- a person performs (directly or indirectly) investment management services for any entity,
- the person holds a disqualified interest with respect to the entity, and
- the value of the interest (or payments thereunder) is substantially related to the amount of realized or unrealized income or gain from the assets with respect to which the investment management services are performed.

In this case, any income or gain with respect to the interest would be treated as ordinary income. Rules similar to the exception for a partner's qualified capital interest apply.

Self-employment tax treatment

Under the provision, in the case of any individual who is engaged in the trade or business of performing services (as described in the provision) with respect to any entity, any amount treated as ordinary income or loss from an investment services partnership interest would be taken into account in determining self-employment tax. Because net income or gain from the disposition of an investment services partnership is treated as ordinary income, the present-law exception under the self-employment tax rules for gain or loss from the sale or exchange of a capital asset would not apply, even though the net income from the investment services partnership interest might otherwise be characterized as capital gain. Inclusion in self-employment income would be required, notwithstanding the present-law special rule for limited partners under self-employment tax, so the present-law exclusion for limited partners would not apply to any amount treated as ordinary income or loss from an investment services partnership.

Publicly traded partnerships and REITs

The provision also contains special rules applicable to publicly traded partnerships and REITs.

Implementation

Regulatory authority

The provision would grant the Secretary of the Treasury broad authority to write regulations and other guidance to carry out the purposes of the provision, to prevent the avoidance and to coordinate with other provisions of the Code.

Penalties

The provision would increase the underpayment penalty to 40 percent in the case of an underpayment attributable to a failure to comply with the terms of the provision. The reasonable cause exception would not apply to mitigate the penalty unless there was adequate disclosure, substantial authority for the tax treatment, and a reasonable belief by the taxpayer that the tax treatment was more-likely-than-not the proper tax treatment.

Effective date

The legislation would be effective for dispositions of partnership interests and partnership distributions occurring after Dec. 31, 2009 — regardless of when the interest was originally granted. The rule for transfers of partnership interests under Section 83 would be effective for partnership interests transferred after the date of enactment. The rule treating net income from an investment services partnership interest as ordinary income would be effective generally for taxable years ending after Dec. 31, 2009. A special allocation rule would apply for tax years that include Dec. 31, 2009. The provision for income or gain with respect to interests in certain entities other than partnerships that are held by a person who performs investment management services directly or indirectly for the entity would take effect on Jan. 1, 2010. The rules on publicly traded partnerships would apply to taxable years beginning after Dec. 31, 2009.

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