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May 11, 2010

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Re: Update of ABA Section of Taxation Comments on H.R. 2834 with respect to H.R. 4213

Gentlemen:

These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These comments update the Section of Taxation's previous comments¹ concerning the proposal in H.R. 2834 (the "Prior Legislation") to alter the taxation of certain carried interests. These comments address issues with regard to the proposal in the Tax Extenders Act of 2009, H.R. 4213, as passed by the House of Representatives on December 9, 2009 (the "Current Legislation"),² to alter the taxation of certain carried interests.

The following Investment Services Partnership Interest ("ISPI") definitional issues, issues related to qualified capital interests, and issues arising from the interaction of the carried interest proposals with other sections of the Internal Revenue Code³ were discussed in our comments on the Prior Legislation and have not been resolved in the Current Legislation:

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- 1 ABA Section of Taxation "Comments on H.R. 2834" (November 13, 2007), available at <http://www.abanet.org/tax/pubpolicy/2007/071113commentshr2834.pdf>.
 - 2 The Senate amendments to the Current Legislation included deleting the proposals with respect to the taxation of carried interests and changing the name of the bill to the American Workers, State, and Business Relief Act of 2010. The Senate passed an amended version of the Current Legislation on March 10, 2010.
 - 3 References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), and references to a "proposed section" are to a proposed section of the Code included in the Current Legislation.

ISPI Definitional Issues

- The requirement in proposed section 710(c)(1) that the services to be performed by the holder of an ISPI must be in a “substantial quantity” presents questions with respect to quantifying services and from which perspective the determination of the quantity of services is to be made;
- The determination of whether a taxpayer’s services will rise to the necessary quantum of services presents issues with respect to the potential imputation of activities and the effect of services provided by related parties;
- The type of supporting services that will cause a partner that does *not* provide the other specified services as to real estate, securities, commodities, and partnership interests to have an ISPI;
- The policy rationale for treating partnership interests as ISPIs when the partnerships issuing such interests may have assets that are not real estate, securities or commodities and may have been established for liability or other reasons;⁴
- The policy rationale for not treating as an ISPI a partner’s interest in an entity with no real estate, securities, commodities or partnership interests, while treating the same partner’s interest in an entity with real estate, securities, commodities or partnership interests, as well as assets of other types, as an ISPI with respect to the assets of other types;
- Whether a partnership interest is unitary (as it is for adjusted tax basis purposes) when testing to see if it is an ISPI or whether later issuances of partnership interests are considered distinct interests that may separately be treated as ISPIs if expectations have changed;
- Whether the Current Legislation should include exceptions relative to the size or other characteristics of a partnership, the partnership’s primary business, or the size or other characteristics of the partner or the partnership interest;
- The scope of the “directly or indirectly” concepts in proposed section 710(c)(1) in the context of, for example, tiered partnerships and affiliated partnerships;

Qualified Capital Interest Issues

- The differentiation between ISPIs and purchased interests, which are referred to in proposed section 710(c)(2)(E)(ii) as qualified capital interests (“Qualified Capital Interests”), given the variety of situations in which various services are provided to, and capital investments are made in, partnerships and related entities by taxpayers and parties related to the taxpayers;
- The differentiation between contributed cash and undistributed, previously taxed partnership income because, although under the Current Legislation income from the receipt of the partnership interest and income recharacterized by

⁴ Neither this letter nor our comments on the Prior Legislation directly consider the policy behind the asset classes specified in the Prior Legislation or the Current Legislation.

proposed section 710 are considered the same as contributed cash, undistributed, previously taxed partnership income to which proposed section 710 does not apply is not treated as contributed cash and the rationale for this exclusion of previously taxed partnership income;

- The differentiation between amounts contributed to the partnership in exchange for an interest and amounts paid to acquire an interest, which is an ISPI in the hands of the purchaser;
- Whether Qualified Capital Interests should account for a partner's obligations to make contributions in the future (*e.g.*, a general partner's obligations for the partnership's liabilities);
- The extent to which bona fide loans (including loans from other partners) may be used by service providing partners without being subject to proposed section 710(c)(2)(E);
- The determination of whether allocations are "significant" under proposed section 710(c)(2)(A)(ii)⁵ compared to allocations made to other qualified capital interests held by partners that do not provide the services described in proposed section 710(c)(1);
- The identification of nonservice providers and which items would be "properly allocable" to the Qualified Capital Interest for which proposed section 710(c)(2)(B) grants regulatory authority and for which additional statutory rules would be helpful;

Issues Arising from Interaction with Other Code Provisions

- Whether the comparison of allocations to Qualified Capital Interests and allocations to ISPIs is annual, multi-year, or based on other periods;
- The application of section 409A to an ISPI;
- Whether a separate basis would be tracked with respect to an ISPI that is, in part, a Qualified Capital Interest and the issues that would arise if separate bases were to be tracked (including the effect on allocations of liabilities);
- The interaction between proposed section 710 and other loss limitation rules;
- Whether taxpayers may aggregate income and losses from ISPIs in different partnerships (or in the same legal entity when there is an intervening termination under section 708) and, if so, how such aggregations would be made;
- Whether the recharacterization of income by proposed section 710 would apply for all purposes of the Code or only for purposes of section 1 and the sections conformed by the Current Legislation;

⁵ This determination of significance replaces the a testing of the "reasonability" of the allocations under proposed section 710(c)(2)(A)(ii) of the Prior Legislation.

- Whether the recharacterization of income is intended to effect the application of treaty provisions that require character flow through;
- The effect of recharacterized income on the substantial economic effect of allocations for purposes of section 704(b);
- The interaction between proposed section 710 and existing section 707(a)(2)(A);
- The interaction between section 751 and the recharacterization caused by proposed section 710 and the provisions in the Current Legislation for Qualified Capital Interests;

Issues Arising from the Effects on Partners Not Holding ISPIs

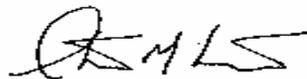
- The handling for partners that do not have ISPIs of the distortions caused by the lack of a deduction associated with recharacterized income or gain; and
- The effect on foreign or tax-exempt partners that do not hold ISPIs but hold interests in partnerships that hold ISPIs.

Each of these concerns is explained in more detail in our comments on the Prior Legislation. Additions to the Prior Legislation present additional issues that we plan to address in separate comments.

Finally, as is often the case with tax legislation, we are concerned that the Current Legislation would increase the complexity of the tax system and thereby impose additional compliance burdens on both the Internal Revenue Service and taxpayers. We urge the Congress to carefully consider complexity as it evaluates the merits of the Current Legislation and similar legislation.

We appreciate your consideration of these comments. Representatives of the Section would be pleased to discuss this letter with you or your respective staffs. Please contact Helen Hubbard, the Section's Vice Chair for Government Relations, at (202) 528-5217 if that would be helpful.

Sincerely,



Stuart M. Lewis
Chair, Section of Taxation

Attachment

cc: Mr. John L. Buckley, Majority Chief Tax Counsel, House Ways and Means Committee
Mr. Russell Sullivan, Majority Staff Director, Senate Finance Committee
Mr. Jon Traub, Minority Staff Director, House Ways and Means Committee
Mr. Kolan Davis, Minority Staff Director, Senate Finance Committee
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation



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November 13, 2007

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The Honorable Charles E. Grassley
Ranking Member
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Re: ABA Section of Taxation Comments on H.R. 2834

Gentlemen:

Enclosed are Comments on H.R. 2834, a bill that would recharacterize income allocations of partnerships as ordinary income to the extent that the allocations are made with respect to an interest in a partnership received for services (*i.e.*, a “carried interest”). These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Chair, Section of Taxation
Stanley L. Blend

Enclosure

cc: John L. Buckley, Majority Chief Tax Counsel, House Ways and Means Committee
Jon Traub, Republican Chief Tax Counsel, House Ways and Means Committee
Edward Kleinbard, Chief of Staff, Joint Committee on Taxation
Russell Sullivan, Staff Director, Senate Finance Committee
Kolan Davis, Republican Staff Director, Senate Finance Committee
Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
Karen G. Sowell, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Michael J. Desmond, Tax Legislative Counsel, Department of the Treasury
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AMERICAN BAR ASSOCIATION SECTION OF TAXATION COMMENTS ON H.R. 2834

These comments (“Comments”) submitted on behalf of the American Bar Association’s Section of Taxation (the “Section”), address H.R. 2834, a bill that would recharacterize income allocations of partnerships as ordinary income to the extent that the allocations are made with respect to an interest in a partnership received for services (*i.e.*, a “carried interest”).¹ These Comments were approved by the Section’s Council and represent the position of the Section. However, these Comments have not been approved by the House of Delegates or Board of Governors of the American Bar Association and thus should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Adam M. Cohen and Sheldon I. Banoff. Significant contributions also were provided by Paul D. Carman, William H. Caudill, R. Brent Clifton, Terence F. Cuff, Will Dixon, Steven G. Frost, Phillip Gall, Monte A. Jackel, Robert R. Keatinge, Matthew Lay, Stephen A. Lee, David Miller, Susan Mello, Bahar Schippel, Eric Sloan, and Kevin Thomason. These Comments were reviewed by Eric Sloan, Chair of the Section’s Partnerships and LLCs Committee. The Comments were further reviewed by Barbara Spudis de Marigny, Council Director for the Partnerships and LLCs Committee, Emily Parker for the Energy and Environmental Taxes Committee, and Priscilla Ryan for the Employee Benefits Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who will be affected by the federal income tax rules applicable to the subject matter addressed by these Comments or have advised clients on the application of such rules, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to or otherwise to influence the development or outcome of the specific subject matter of these Comments.

Contact Person: Adam M. Cohen
(303) 295-8372
acohen@hollandhart.com

Date: November 13, 2007

¹ These Comments were prepared prior to the introduction of H.R. 3970, the “Tax Reduction and Reform Act of 2007,” and do not address provisions of that bill which differ from those contained in H.R. 2834.

Executive Summary

On June 22, 2007, Representative Sander M. Levin (D-MI) introduced H.R. 2834 with 21 co-sponsors.² On August 3, 2007, Representative John B. Larson (D-CT) introduced H.R. 3417 to “Establish the Commission on the Tax Treatment of Hedge Funds and Private Equity.” The Senate Committee on Finance held hearings on issues similar to those covered by H.R. 2834 on July 11, 2007, July 31, 2007, and September 6, 2007. A hearing on similar issues also was held by the House Committee on Ways and Means on September 6, 2007.

H.R. 2834 would recharacterize income allocations of a partnership as ordinary income to the extent the allocation is made with respect to a carried interest. We understand that H.R. 2834, and other similar bills under consideration by the Senate Committee on Finance and the House Committee on Ways and Means, have been introduced to address tax policy issues that have arisen through recent discussion and debate regarding the nature of compensation earned by managers of certain investment funds.³

The current rules regarding the taxation of carried interests have developed over more than thirty years, and the principles underlying those rules apply to a wide variety of partnerships. In light of the significance of these rules, the Tax Section established a task force to study the history and rationale behind the current rules and to identify and consider the interpretative and administrative issues that may arise if legislation such as that embodied in H.R. 2834 were to be enacted. The task force consists of lawyers with considerable expertise in the taxation of partnerships, real estate, cross-border transactions, oil and gas ventures, and employee benefits matters.

These Comments provide a brief background on the current rules regarding the taxation of carried interests and the provisions of H.R. 2834 that would alter those rules. The Comments then discuss and analyze a number of interpretative and administrative issues that, to the extent not addressed legislatively, likely will require the issuance of regulations or other guidance by the Treasury Department (“Treasury”) and the Internal Revenue Service (the “Service”).

As is often the case with tax legislation, we are concerned that legislation such as that contained in H.R. 2834 would increase the complexity of the tax system and thereby impose additional compliance burdens on both the Service and taxpayers. We urge the Congress to carefully consider this important concern as it evaluates the merits of H.R. 2834 and similar legislation.

² Representatives Abercrombie, Conyers, Filner, Gutierrez, Kind, Lewis, Neal, Pascrell, Rangel, Sherman, Welch, Blumenauer, DeFazio, Frank, Jones, Larson, McDermott, Norton, Pomeroy, Sarbanes and Stark.

³ See note 1 above.

Finally, in light of the significant changes that would result from the enactment of H.R. 2834 or similar legislation, we respectfully suggest that Congress carefully consider the effective date(s) established for any such legislation. Many existing arrangements were established in reliance on the long-standing current rules; changing the rules applicable to existing arrangements should be approached with care. Even for new interests issued after the date of enactment (or some other date certain), we recommend that Congress consider providing a delayed effective date or other transition relief in order to provide sufficient time for Treasury and the Service to develop and issue guidance, and for taxpayers to understand and comply with any such legislation and guidance.

Background

A. Overview of Current Rules Relating to the Taxation of Carried Interests

Section 83 provides that property transferred to any person in connection with the performance of services will be included in the gross income of the person who performed the services in the first taxable year in which the rights of the person are transferable or not subject to substantial risk of forfeiture.⁴ The amount of gross income includable on such an event is equal to the excess of the fair market value of such property at such time over the amount paid for the property.⁵ An election is available under section 83(b) to disregard a risk of forfeiture and to include the transfer in gross income in the year the property is transferred. The current regulations under section 83 do not specifically address transfers of partnership interests. However, Treasury Regulation section 1.83-3(e) defines property to include real and personal property other than either money or an unfunded and unsecured promise to pay money for property in the future.

Section 721 states that “no gain or loss is recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.” In 1956, Treasury Regulation section 1.721-1(b) was issued and provided in part that “To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation (or in satisfaction of an obligation), section 721 does not apply.” That regulation provided that “the value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.” In 1971, Proposed Treasury Regulation section 1.721-1(b) was issued, which would have provided that the transfer of an interest in partnership capital was a transfer of property and the timing of recognition and the amount of income recognized was to be determined under section 83 and the regulations thereunder.⁶ (That Proposed Regulation was never finalized and was withdrawn in 2005.)⁷

Also in 1971, the Tax Court held that the receipt of an interest in a partnership, in connection with services provided to the partnership, entitling the partner solely to profits, that was sold by the partner fewer than three weeks after he acquired the interest, was a compensatory transfer of property and that the value of the interest was the value at

⁴ Unless otherwise indicated, references to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and references to a “proposed section” are to a proposed section of the Code contained in H.R. 2834.

⁵ Section 83(a).

⁶ 36 Fed. Reg. 10787 (June 3, 1971).

⁷ 70 Fed. Reg. 29675 (May 20, 2005).

which it was sold.⁸ In 1984, the Tax Court and the U.S. District Court for the Central District of Illinois decided in separate cases that the receipt of an interest in the profits of a partnership in connection with services should be included as compensation income based on the liquidation value of the interest.⁹ And in 1991, the Eighth Circuit held that the receipt of an interest in partnership profits, in connection with services, was not includable in income because the value of the interest was speculative.¹⁰

In Revenue Procedure 93-27, the Service stated that it would not treat the receipt of certain profits interests received for services as a taxable event for either the person receiving the interest or for the partnership.¹¹ To qualify for this treatment, the profits interest could not relate to a substantially certain and predictable stream of income from partnership assets, could not be disposed of within two years of receipt, and could not be a limited partnership interest in a publicly-traded partnership. Because of the lingering uncertainty regarding the full impact of Revenue Procedure 93-27, the Service promulgated Revenue Procedure 2001-43,¹² which clarified that Revenue Procedure 93-27 would be applied at the issuance of the profits interest regardless of whether the interest is subject to a substantial risk of forfeiture, if the partnership and service provider treat the service provider as the owner of the partnership interest from the date of grant, the service provider takes into account the distributive share of partnership income, gain, loss, deduction and credit associated with that interest for the entire period during which the service provider holds the interest, and neither the partnership nor any partner deducts any amount as wages, compensation, or otherwise for the fair market value of the interest at any time. In light of these clarifications, Revenue Procedure 2001-43 stated that taxpayers to which it applies need not file an election under section 83(b).

The foregoing revenue procedures do not apply to issuances of partnership interests in connection with services that do not qualify as profits interests (*i.e.*, capital interests or interests in a partnership that are entitled to a share of the proceeds on a liquidation of the partnership at the time of issuance). Because capital interests are not covered by the revenue procedures but are transfers of property in exchange for services, it seems clear that section 83 controls the service provider's timing and amount of income. A substantially vested capital interest will be taxable on issuance and an unvested capital interest will be taxable upon vesting or upon grant if an election is made

⁸ *Diamond v. Commissioner*, 56 T.C. 530 (1971).

⁹ *See Kenroy v. Commissioner*, T.C. Memo 1984-232; *St. John v. United States*, 84-1 U.S.T.C. 9158, 53 A.F.T.R.2d 84-718.

¹⁰ *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), *aff'g in part and rev'g in part*, T.C. Memo 1990-162. *See also* Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I*, Sept. 4, 2007, JCX-62-07, at page 25, fn. 43.

¹¹ 1993-2 CB 343.

¹² 2001-2 CB 191.

under section 83(b). The service provider will have income equal to the difference between the amount paid for the interest and the fair market value of the interest at the time it becomes taxable to the service provider.¹³

In 2005, Treasury and the Service promulgated Proposed Regulations and a proposed revenue procedure regarding partnership equity for services.¹⁴ These Proposed Regulations generally would require grants of partnership interests for services to be taxed in accordance with section 83. However, consistent with the current treatment of profits interests, the Proposed Regulations and proposed revenue procedure contain a mechanism by which taxpayers would be permitted to elect to treat the fair market value of such interests as being equal to the liquidation value of such interests. This mechanism would apply, if elected, to all transfers of partnership interests in connection with services by the electing partnership, whether the interests are profits interests or capital interests.

Treasury and the Service initially identified these rules as an area of interest in Notice 2000-29, in response to which individual members of the Section of Taxation submitted comments dated January 30, 2002.¹⁵ After promulgation of the Proposed Regulations, further comments dated December 29, 2005 were submitted by individual members of the Section of Taxation.¹⁶ These later comments commended Treasury and the Service for taking substantial steps forward in clarifying the issues relating to transfers of partnership interests in connection with the performance of services. The later comments also made a number of suggestions for improving the Proposed Regulations.

Whether a service provider receives a capital interest or a profits interest, after the issuance (or after vesting, with regard to a substantially unvested interest for which no section 83(b) election is made and to which Revenue Procedure 2001-43 does not apply), the service provider is treated as a partner with respect to that interest. The service provider is taxed, under section 702, on his distributive share of partnership income, and any disposition of his interest is governed by section 741. A distributive share that is more properly characterized as a payment for services may be recharacterized as such under section 707(a). However, a partner is not an employee.¹⁷

¹³ See, e.g., *Hensel Phelps Construction Co. v. Commissioner*, 74 T.C. 939 (1980), *aff'd* 703 F.2d 485 (10th Cir. 1983).

¹⁴ 70 Fed. Reg. 29675 (May 20, 2005); Notice 2005-43, 2005-24 I.R.B. 1221.

¹⁵ *Comments In Response To Notice 2000-29*, 56 TAX LAW. 203 (Fall 2002).

¹⁶ 2006 TNT 1-34 (January 3, 2006).

¹⁷ Rev. Rul. 69-184, 1969-1 C.B. 256; *cf.* Rev. Rul. 71-502, 1971-2 C.B. 199.

B. Overview of H.R. 2834

On June 22, 2007, Representative Sander M. Levin (D-MI) introduced H.R. 2834 with 21 co-sponsors.¹⁸ When the bill was introduced the House Committee on Ways and Means issued a press release and “fact sheet” describing the legislation.¹⁹

With the foregoing as background, H.R. 2834 was introduced to alter the taxation of certain carried interests. In summary, the bill provides a general rule that, in the case of an “investment services partnership interest”:

- (1) any net income (*i.e.*, the excess of all items of income or gain under section 702(b), over all items of deduction and loss) that is allocated with respect to such interest for any partnership taxable year will be treated as ordinary income for the performance of services);²⁰
- (2) any gain recognized on the disposition of an investment services partnership interest will be treated as ordinary income for the performance of services;²¹ and
- (3) in the case of any distribution of appreciated property by a partnership with respect to an investment services partnership interest, the partnership will recognize gain in the same manner as if it sold such property at fair market value at the time of distribution.²²

Under H.R. 2834, these three recharacterization rules generally apply to a partner’s entire “investment services partnership interest,” rather than to only the portion of the interest that is acquired or owned with respect to the rendering of services.²³ A narrow exception to the recharacterization rules may apply to the extent a portion of the “investment services partnership interest” is acquired on account of a contribution of invested capital.²⁴

The potential application of these recharacterization rules and the exception turns on the meaning and scope of several terms used in the statute (and of words and phrases used within those statutory definitions). Key elements of the rules include the meaning

¹⁸ See note 2 above.

¹⁹ Press Release, Levin, Democrats Introduce Legislation to End Carried Interest Tax Advantage (June 22, 2007) (on file with Committee on Ways and Means).

²⁰ Proposed section 710(a)(1)(A), (a)(3)(A).

²¹ Proposed section 710(b)(1).

²² Proposed section 710(b)(4).

²³ Proposed section 710(a)(1)(A), (b)(1) and (c)(1).

²⁴ Proposed section 710(c)(2).

of the terms (1) “investment services partnership interest” (defined in proposed section 710(c)(1)); (2) “invested capital” (defined in proposed section 710(c)(2)(C)); (3) “reasonable allocation of partnership items” (defined in the negative in proposed section 710(c)(2)(A)); and (4) a “substantial quantity of ... services” (used without explanation in the definition of an “investment services partnership interest”).

H.R. 2834 also contains rules relating to: (i) the treatment as ordinary loss of certain losses with respect to an “investment services partnership interest;”²⁵ (ii) the limited application of the bill to real estate investment trusts that provide services that otherwise would cause the recharacterization rules under proposed section 710 to apply (so that the legislation would not affect an entity’s ability to qualify as a REIT);²⁶ and (iii) the amendment of section 1402(a)(13) to provide that the recharacterized income may be includable in net earnings from self-employment and similar conforming amendments to section 211(a)(12) of the Social Security Act.

²⁵ Proposed section 710(a)(1)(B), (a)(2).

²⁶ Proposed section 856(c)(8).

Discussion

A. Differentiating among Interests Based on Type of Services Provided

By its terms, H.R. 2834 would apply only to an interest in a partnership “which is held by any person if such person provides (directly or indirectly), in the active conduct of a trade or business, a substantial quantity” of certain services with respect to specified assets.²⁷ The services listed are: (1) advising as to value, (2) advising as to advisability of investing in, purchasing or selling such assets, (3) managing, acquiring or disposing of such assets, (4) arranging financing with respect to acquiring such assets, and (5) any activity in support of the foregoing. Specified assets are securities, real estate, commodities or options or derivative contracts with respect to such assets. These concepts raise a number of interpretive issues.

It is unclear whose trade or business is considered. Must the person providing the services actively be conducting a trade or business separate and apart from any trade or business that the partnership might be conducting? Alternatively, it may be the partnership (and not the partner) that must be in an active trade or business.

The type of trade or business appears irrelevant. The bill does not make any qualification as to the trade or business other than that it must be active. Would H.R. 2834 apply if the specified assets (*e.g.*, real estate or commodities) are supportive of the partnership’s principal trade or business, but do not constitute the conduct of a separate trade or business of real estate, commodities or securities acquisition or investment? Is the requirement that the trade or business be “active” the same as, or different from, the standard set forth in section 355?

The requirement that the services be of a “substantial quantity” raises several practical questions. It can be difficult to quantify services. Services may be measured in time spent.²⁸ Services can also be quantified by the amount paid for such services and some services are difficult to quantify (such as simply being a partner). In some cases, service providers promise to set aside a minimum amount of time for a partnership’s services (although all of that time may not actually be devoted to the partnership’s activities). The phrase also raises questions regarding when such quantity of services (however measured) is substantial. Substantiality might be viewed from the service provider’s perspective, the partnership’s perspective, the industry’s perspective, relative to the job type, or other benchmarks.

In measuring whether a person provides “a substantial quantity” of any of the services listed in proposed section 710(c)(1), questions may arise as to imputation of activities and the impact of related parties. For example, if the partner receiving the

²⁷ Proposed section 710(c)(1).

²⁸ *See, e.g.*, section 469 and Prop. Treas. Reg. § 1.1402(a)-2(h)(2)(iii).

carried interest is an entity, it can only provide services through its employees, agents, or other representatives. Presumably, those activities should be imputed to the entity partner. The same question of imputation occurs in other contexts as well; that is, the partner could be a shareholder in a corporation the employees of which provide the services to the partnership on behalf of the partner, or the partner could be an individual who hires other individuals to perform services for the partnership on behalf of the partner. Are activities of a partner's employees or agents or persons related to the parties, imputed to that partner in circumstances where the partner is receiving a carried interest? Moreover, should the activities of an independent contractor who is directly engaged by a partner receiving a carried interest be treated as being provided by the partner himself or itself? If imputation applies, it becomes critical to define how far imputation must be taken. For example, if partners (who do not provide services to the partnership) are allowed to invest because of their relationship with the service provider, will the services provided be imputed to the investor partners? There will also be many difficult factual distinctions to be made if imputation applies.

Similarly, a partner may provide services with respect to the entire range of assets held by the partnership, some of which are not described in proposed section 710. For example, if the partnership holds real estate, securities, or commodities (or options thereon) and also holds other assets, and the partner is providing services with respect to both groups of assets, it is unclear whether the partner's allocations from both groups of assets would be subject to recharacterization, or only the partner's allocations from the real estate, securities, commodities, and related options. If the groups of assets had been held by separate partnerships and the partner had received interests in both partnerships, the allocations from the partnership holding the non-specified assets would not have been recharacterized. If different treatment will exist between the situation in which all of the assets are in a single partnership and the situation in which the assets are held in multiple partnerships (that are otherwise identical), a policy rationale should support such differentiation.

There is also a question regarding the tense used in H.R. 2834 as to when the provision of services is tested. Is an interest that has qualified as an "investment services partnership interest" always treated as such? For example, if a partner provides the covered services in year 2 but does not provide those services in a subsequent year, does proposed section 710 apply only in year 2? If the partner contributed "invested capital" and did not provide the covered services in year 1, does proposed section 710 even apply in year 2 (such that a determination must be made as to whether the allocations between the purchased interest and carried interest are reasonable)? Will the answer change if the partnership agreement is modified in year 2 in a manner that in some way increases the allocations to be made in respect of the interest?

The inclusion of supporting activities in the list of services resulting in an “investment services partnership interest” creates technical questions of scope.²⁹ Are administrative and secretarial assistance included? Does approval or ratification of services by others constitute support of those services? There are various levels of support and services provided by other partners that are not covered that may be supportive of the partner whose services are covered by virtue of the covered service partner not having to concern itself with the other activities of the partnership. For example, a partner that takes care of the supply chain issues in an inventory-reliant industry (*e.g.*, a chain of grocery stores in a partnership that owns the underlying real estate) does not specifically support the covered services, but that partner does allow another partner to focus on managing the partnership’s investment portfolio, commodity hedging or store development functions.³⁰

From a tax policy perspective, consideration should be given to whether the covered assets specify the correct focus of the legislation. The specified assets are held by a variety of partnerships in a variety of ways. For example, some real estate is held as inventory, some is held as assets described in section 1231 and some is held as capital assets. The legislation might focus only on assets held for a particular purpose (*e.g.*, only capital assets).

The ultimate scope of H.R. 2834 should likewise be considered. Other differentiating factors that might be used for defining the scope of legislation of this type include: (1) the size of the partnership (*e.g.*, whether by number of partners, number of partners providing the covered services, the asset base of the partnership, the value of the specified assets held by the partnership, or other quantitative measurement standards), (2) partnerships with certain other characteristics (*e.g.*, a lack of significant assets other than the specified assets), (3) the industry of the partnership’s primary business, (4) the size or net worth of the partner, or (5) the size of the partner’s interest (*e.g.*, measured in value or percentage interest).³¹ Because the application of H.R. 2834 may give rise to many complexities, including those discussed below, consideration might be given to whether small business, small partnership or small partner exceptions should be provided.

²⁹ The issues as to imputation of services discussed above also apply to these ancillary services.

³⁰ Store development functions presumably would involve substantial services advising the partnership on the value of its real estate, the advisability of purchasing or selling particular parcels, managing, acquiring or disposing of potential store sites, and arranging financing with respect to acquiring such real estate.

³¹ If any of these factors are utilized, consideration should be given to how to treat situations in which a threshold is exceeded in one year and not exceeded in the following year (and vice versa).

B. Differentiating Between Carried Interests and Purchased Interests

1. Capital Contributions Do Not Provide a Reliable Differentiating Mechanism

H.R. 2834 provides a general rule that, if a partner holds an “investment services partnership interest,” all of the partner’s allocated or disposition income and gain, rather than just the portion of the income or gain properly attributable to the rendering of services, is recharacterized as ordinary income for the performance of services.³² An exception to this recharacterization rule would apply if a portion of an investment services partnership interest is acquired on account of a contribution of “invested capital.” When this exception applies, with respect to allocated income and gain, if the partnership makes a reasonable allocation of partnership items between the portion of the distributive share that is “with respect to invested capital” and the portion of such distributive share that is “not with respect to invested capital,” the provisions of H.R. 2834 that recharacterize allocated income and gain would not apply to the portion of the distributive share that is with respect or attributable to invested capital.³³ The bill defines “invested capital” as the fair market value at the time of contribution to the partnership of any money or other property contributed to the partnership.³⁴ For purposes of recharacterizing a partner’s distributive share, allocations between the portion with respect to invested capital (the “purchased interest”) and the carried interest portion would not be reasonable if a service provider’s allocation is greater than the allocation to any other partner with respect to the same amount of invested capital.³⁵ For purposes of recharacterizing disposition gain into ordinary income for the performance of services, the portions of the disposition gain attributable to the carried interest and the purchased interest received in connection with the contribution of money or other property is determined as if the partnership sold all of its assets immediately before the disposition and allocated the resulting gain.³⁶

The disparate treatment for carried interests and purchased interests will make the distinction between these interests of utmost importance. Given the fluid nature of many partnerships, it often will be very difficult to make this distinction. Many taxpayers who perform services for partnerships make capital contributions to those partnerships and many taxpayers that are primarily providing capital to their partnerships provide some level of services to the partnership.

³² Proposed section 710(a)(1)(A), (b)(1), (c)(1).

³³ Proposed section 710(c)(2)(A).

³⁴ Proposed section 710(c)(2)(C).

³⁵ Proposed section 710(c)(2)(A).

³⁶ Proposed section 710(c)(2)(B).

Even in simple partnerships, the distinction may become difficult to draw. In some partnerships, one or more partners will provide the capital and have limited management authority and one or more partners will provide solely services. However, even in such partnerships, if the cash or property associated with the partnership's profits is not fully distributed, a service providing partner will end up with a positive capital account balance. If the cash or property had been fully distributed and the service providing partner re-contributed the cash or property received, it seems that, under the bill, the service providing partner would have some portion of its interest that is a purchased interest.³⁷ As the origin of the capital account balance in the two situations is economically indistinguishable, there does not appear to be a strong policy rationale for differentiating between contributed cash and property, on the one hand, and cash and property (previously taxed as distributive share) that is retained by a partnership, on the other hand.³⁸

General partners of a limited partnership must manage their partnership and may invest capital in their partnership, but also are subject to the partnership's liabilities. In certain circumstances, such a general partner may be required to expend its entire net worth to satisfy those liabilities. Consideration should be given to whether H.R. 2834 should credit a general partner with contributing its entire net worth when determining the invested capital of the general partner.

The grant of a capital interest (or the grant of a profits interest to which Revenue Procedure 93-27 does not apply) may fall within the scope of carried interests affected by H.R. 2834. This is due to the definition of "investment services partnership interest" applying to "any interest in a partnership" if the holder meets certain criteria and the only exception applying to "invested capital," which itself is defined to include only "money or other property contributed to the partnership." It is unclear, under the bill, how such an interest (on which tax was paid in connection with issuance but as to which it is unclear under current law whether any contribution has been made by the recipient) would be treated. If the partnership had distributed the cash, the partners had transferred the cash to the service provider (the receipt of which was taxed) and the service provider contributed that cash to the partnership (or if the partnership had transferred cash directly

³⁷ This can be exemplified by the simple situation in which two founders establish a partnership for minimal cash or property contributions and agree to share profits and losses equally. At a time when the partnership's assets have substantially appreciated in value (for example, to \$2 million), an investor contributes \$1 million for a one-third interest. Under Treas. Reg. § 1.704-1(b)(2)(iv)(f), the capital accounts of the founders will be increased to \$1 million each immediately prior to the investor's contribution. If the founders distributed the goodwill or other assets that had substantially appreciated and re-contributed those assets immediately prior to the investor's contribution, the founders would each receive their one-third interests for invested capital. There does not appear to be a policy rationale for requiring such distribution and re-contribution.

³⁸ It may not be feasible for a partnership to distribute all of its capital at any particular time. The assets may be subject to, among other things, loan covenants and legal restrictions that may prevent distribution and re-contribution.

to the service provider in a taxable transfer followed by a contribution of the cash to the partnership by the service provider), future allocations with respect to such interest would be “with respect to invested capital” and thus presumably not subject to H.R. 2834’s operation. An issuance of a capital interest (or a grant of a profits interest to which Revenue Procedure 93-27 does not apply) is indistinguishable from such a situation.

Consideration also should be given to whether mechanisms that might be utilized by service providers to avoid the application of H.R. 2834 will be allowed. For example, a non-recourse loan made to the service provider, the proceeds of which the service provider uses to purchase an interest, would allow the service provider to receive what (absent the loan) would have been a carried interest subject to H.R. 2834. Will such interests be subject to H.R. 2834? If a provision is created to capture such structures, care should be taken to allow partners to obtain bona fide loans to make capital investments (including loans from other partners), even where such partners will also provide services to the partnership.

2. Allocations between Carried Interests and Purchased Interests

H.R. 2834 states that the recharacterization of income and gain can be avoided for an interest received for invested capital if the partnership’s allocations of distributive share between interests received for invested capital and interests that are not received for invested capital are reasonable.³⁹ The bill provides that an allocation is not reasonable if the allocation results in the partnership allocating a greater portion of income to invested capital than any other partner not providing services would have been allocated with respect to the same amount of invested capital.⁴⁰ This presents difficulties in identifying partners that do not provide services and in the different investment return profiles sought by different investors.

Many partnerships obtain some level of participation from the partners, making it difficult to identify a partner that provides no services (and thus difficult to identify a partner whose allocation is attributable entirely to invested capital). The Revised Uniform Limited Partnership Act (“RULPA”), for example, allows limited partners to engage in a fairly broad set of actions and still avoid liability for the partnership’s obligations. In adopting RULPA (or their own limited partnership acts), States can modify this set of permissible actions. Thus, from State to State (in addition to partnership to partnership), different limited partners may be providing services at different levels, and there may be no partner that provides no services. H.R. 2834 does not address whether a *de minimis* level of services would be disregarded. If H.R. 2834

³⁹ Proposed section 710(c)(2)(A).

⁴⁰ Proposed section 710(c)(2)(A), last sentence.

contained an exception for a *de minimis* level of services, the provision could be consistent with the limited partnership act of the State of formation of the partnership.⁴¹

In addition, there may be great variety in the allocations that each investor receives from a partnership. Investors often have different risk tolerances and return expectations. Thus, one investor may receive a preferred return on and of capital, while another investor may be willing to forgo the preferred return for a larger residual interest in partnership profits. H.R. 2834 does not address what allocations are to be relied upon to determine whether an allocation is reasonable.

When partners are admitted on different dates, partners contributing the initial or start-up capital, for valid non-tax reasons, may be allocated and receive a greater amount of income (based on a priority cumulative return, an initial rate of return, or other mechanism) than a partner entering later and contributing the same amount of invested capital. If the service provider is a partner who contributes some or all of the initial capital (pending other investing partners making their capital contributions), will the service provider's preferential return cause that partner's allocation of the distributive share to "not be treated as reasonable" under proposed section 710(c)(2), with the result that the partner will fail to qualify for the invested capital exception?

The inverse situation may also occur. The founder of a partnership may invest funds with some initial investors (often friends and family of the founder). Given the "directly or indirectly" language of proposed section 710(e)(1), could the partnership interests of these initial investors (obtained due to their relationship with the founder) be "investment services partnership interests"? Often, while the profits, losses and distributions are made to the partners in proportion to the amount of their respective initial investments (with no additional return being allocated to the service providing founder), a partner that is admitted at a later time may receive a preferential share of profits and distributions over the entire group of initial investors. In this situation, determining whether an allocation with respect to invested capital (compared to the allocations to the "investment services partnership interests") is reasonable will become very difficult.⁴²

⁴¹ While most limited liability company acts do not have similar provisions, the legislation could make such *de minimis* exceptions apply to limited liability company members as well.

⁴² For example, assume A, B, and C each contributes an equal amount of cash for one-third partnership interests. B and C are A's mother and sibling. B and C will provide no services to the partnership but A will provide services that would cause his partnership interest to be an "investment services partnership interest." Will B and C be treated as having "investment services partnership interests" due to the provision of services by A? If so, how are A, B, and C to avail themselves of the "reasonable allocation" exception in proposed section 710(c)(2)? Further, assume D is admitted at a later time and receives a preferential share of profits and distributions over A, B, and C. Will allocations to A be compared to the allocations with respect to D's invested capital or with respect to B's and C's invested capital?

Section 706(d) provides rules for determining partners' distributive shares where interests vary during the year. Additionally, from year to year, partners may amend their partnership agreement to vary the allocations to the partners. Even without an amendment, the allocations may vary among the partners from year to year. In determining whether an allocation as to invested capital is reasonable, the variations that can occur from year to year will need to be taken into account. Are the allocations to be tested only within a particular tax year or will they be tested over the life of the partnership (or some shorter period of years)?

C. Taxation of Issuance or Vesting of Carried Interest – Timing and Potential Double Taxation

As a general rule, section 83 governs the timing and amount of a taxpayer's income from property received in connection with services. Generally, the income event occurs only one time, either (1) in the first year that the property is transferable or is not subject to a substantial risk of forfeiture or (2) in the year of transfer if an election is made under section 83(b). When the income event occurs, the amount included in income is generally the difference between the fair market value of the property received and the amount paid for the property. While not entirely clear, H.R. 2834 does not appear to change this result.

Under the existing revenue procedures relating to transfers of profits interests, only profits interests that do not meet the criteria of those revenue procedures are required to be valued and, to the extent of any such value (in excess of any amount paid for such interests), included in income for federal income tax purposes.⁴³ Taxpayers who receive capital interests are taxed on the fair market value of such interests (reduced by the amount, if any, paid for such interests). Thus, an income event with respect to the receipt of the partnership equity for services occurs in accordance with section 83.

To the extent that the value of partnership equity is not based solely on the liquidation value of such interest on the date of the income event, a portion of the partnership equity may be based on the expected future profits to be allocated and distributed with respect to the interest. To that extent, the recipient will have compensation income twice if H.R. 2834 is enacted: once at the date of grant, and a second time when the actual profits are earned by the partnership and allocated to the partners.

Taxing the same income twice to the same person as income from services is atypical under federal income tax law. After a taxpayer receives stock for services, for example, and pays tax on the receipt of the stock in accordance with section 83, any

⁴³ Rather than being an exception to the application of section 83, the revenue procedures appear to represent an administrative concession that the fair market value of a profits interest that meets the criteria of the revenue procedures is measured by its liquidation value, *i.e.*, zero, or else is of such speculative value as to be appropriately or approximately valued at zero.

qualified dividend income and any gains on the sale of the stock (in excess of the sum of the amount paid for the stock plus the section 83 income on the receipt of the stock) are generally taxed at capital gains rates. Partnership interests transferred for services that do not fall within the scope of H.R. 2834 will likewise only be treated as compensation once. On the other hand, partnership interests that fall within the ambit of H.R. 2834, but outside Revenue Procedure 93-27, will have the receipt treated as compensation and all future allocations of income and gain and all gains on disposition treated again as compensation.

While it is certainly within the ability of Congress to tax the same income twice to the same person as compensation income, consideration should be given to whether an interest that is subject to H.R. 2834 should be excluded from the scope of section 83.⁴⁴ Such an approach would conform the treatment of such interests to the treatment of compensation plans that pay bonuses based on appreciation in the value of the enterprise. These plans, sometimes known as “phantom equity” or “appreciation rights” plans, cause payments to be made to employees at times set under the plan. Because the plans are unfunded and unsecured promises to pay, under section 83, the employee typically does not have taxable income from his receipt of a right to participate in these plans. Instead, the service provider has income under these plans when the payments are made. The income is then entirely ordinary income.

If the income allocated to an “investment services partnership interest” is intended to be treated as deferred compensation, then section 409A also must be considered. Section 409A sets forth certain requirements that must be satisfied to maintain the timing of income under section 83. It is unclear how an interest covered by H.R. 2834 would be addressed by section 409A.⁴⁵ If the recharacterization of income in H.R. 2834 applies, the partnership agreement might be viewed as a nonqualified deferred compensation plan as to which the requirements of section 409A must be met to avoid the additional tax and interest charge under section 409A.

D. Basis Implications

If a partnership interest falls within the scope of H.R. 2834, the bill would recharacterize gain on a disposition of that interest as ordinary income for the performance of services.⁴⁶ Section 731 provides that gain is recognized on certain

⁴⁴ Alternatively, Congress could provide that an “investment services partnership interest” is not subject to proposed section 710 if (or to the extent that) an amount of income is included in income upon receipt of the interest under section 83.

⁴⁵ The final Regulations under section 409A reserved on the treatment of arrangements between partnerships and partners. *See* Treas. Reg. § 1.409A-1(b)(7). However, the preamble to those Regulations advises that taxpayers may continue to rely on the interim guidance provided in Notice 2005-1, 2005-2 I.R.B. 274, Q&A 7, and in section II.E. of the preamble to the Proposed Regulations. *See* T.D. 9321, 72 Fed. Reg. 19234, 19243 (Apr. 17, 2007).

⁴⁶ Proposed section 710(b)(1).

distributions in excess of a partner's basis in the partnership and, if recognized, is considered as being from the sale or exchange of the partnership interest of the distributee partner. Additionally, Revenue Ruling 84-53 provides that a general partner that holds a limited partner interest has a single, combined basis in its partnership interest.⁴⁷ Thus, a partner with a carried interest and a purchased interest may receive a distribution in excess of the basis attributable to the carried interest, which H.R. 2834 may seek to treat as ordinary income (due to being in excess of the carried interest's basis) or as tax-free (due to being less than the combined basis or perhaps because it was received on and properly attributable to the purchased interest). Thus, it may be necessary to calculate separately the basis of a carried interest and a purchased interest held by the same partner.

Assuming that a separate basis for the carried interest must be tracked, one would expect that losses allocated to carried interests, if they are allowed under H.R. 2834, would reduce the basis of the carried interest. However, if such losses are not allowed, the basis of the carried interest should not be reduced, as currently contemplated by H.R. 2834. While not specifically stated in H.R. 2834, it appears that the rules of section 705 would otherwise apply to an interest that is subject to H.R. 2834.

Also, if separate bases are utilized, there will need to be adjustments to take into account a variety of existing rules.⁴⁸ For example, basis in a partnership interest includes the partner's share of the partnership's liabilities under section 752. A partner's share is generally determined by segregating the partnership's liabilities into recourse and non-recourse liabilities (as the Treasury Regulations under section 752 define those concepts) and then allocating the non-recourse liabilities among the partners (with a recourse liability allocated to the partner that bears the economic risk of loss associated with that liability). If H.R. 2834 is enacted, these rules will require modification to determine which portion of a liability allocated to a partner holding both a carried interest and a purchased interest is allocable to each of those interests.

E. Interaction with Loss Limitation Rules

Generally, partnership losses allocated to a partner are subject to four loss limitation rules. Section 704(d) generally prevents losses in excess of a partner's basis in its partnership interest from being utilized by the partner. Passive partners are generally only allowed to utilize losses from the partnerships in which they are passive to the extent they have income from partnerships in which they are passive under section 469. A partner is also only able to utilize losses from a partnership to the extent that partner has a sufficient "at risk" amount under section 465 with respect to the partnership interest. Certain losses of partnerships with tax-exempt and taxable partners are not allowed under

⁴⁷ 1984-1 C.B. 159.

⁴⁸ Adjustments may similarly need to be made to sections 734 and 743 to provide for separately computing a partner's share of inside basis associated with respect to the purchased interest and the carried interest so that basis adjustments under those sections can properly be computed.

section 470 as being associated with “tax-exempt use property” (as generally defined in section 168(h)).⁴⁹

H.R. 2834 would add a fifth loss limitation rule. A net loss on a carried interest that is subject to H.R. 2834 would be allowed only to the extent the loss does not exceed the excess, if any, of the prior income from such interest over the prior losses from the interest.⁵⁰ Similar to a loss limited under section 704(d), a loss limited by the provisions of H.R. 2834 would not reduce the basis of the partnership interest.⁵¹ However, it is unclear whether a loss to which section 704(d) and H.R. 2834 would apply would be limited by one provision, the other, or both (and, if both, in what order).

The interaction of section 469 and the loss limitation rule under H.R. 2834 also would be complicated. Under section 469, the losses are limited if the partner does not provide a certain level of service. Conversely, the loss limitation rule of H.R. 2834 would apply if the partner does provide a certain level of services. It would appear that it is possible for partners to provide enough services to be captured by H.R. 2834, but not enough service to avoid being subject to the rules of section 469. Consideration should be given as to whether partners should be allowed to be subject to both provisions and, if so, the order in which these provisions are applied.

Additional consideration should be given to whether losses from a carried interest to which H.R. 2834 applies in one partnership should be allowed to offset income from another such carried interest in a different partnership. If the partner is providing the covered services as to the specified assets in both partnerships, the partner will be penalized for providing such services to multiple partnerships if H.R. 2834 is enacted in its present form, providing an incentive to put covered assets into a single partnership or to tier the partnerships (in either case likely complicating the partnership agreements, not to mention the compliance requirements for such partnerships and the Service’s task of auditing such partnerships). The loss limitation rules of section 469 (with the exception of passive losses from publicly traded partnerships) allow passive losses from one activity to offset passive income from another activity. On the other hand, the loss limitations of sections 704(d) and 465 (and that applicable to passive losses from publicly traded partnerships under section 469(k)) do not allow such offsetting, instead limiting the utilization of losses only to the particular partnership generating the loss. The operation of section 470 is not entirely clear, although it too appears to operate on a partnership-by-partnership basis.

⁴⁹ Solely for tax years beginning before January 1, 2007, the Service has announced that it will not apply section 470 to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of section 168(h)(6). Notice 2007-4, 2007-2 I.R.B. 260.

⁵⁰ Proposed section 710(a)(2).

⁵¹ Proposed section 710(a)(2)(C). It is unclear whether a loss limited by H.R. 2834 would carry over to the new holder of a covered interest after its disposition. Proposed sections 710(a)(2)(B) and 710(b)(3).

F. Limited or Broad Applicability of Recharacterization

H.R. 2834 would recharacterize income and gain from “investment services partnership interests” as “ordinary income for the performance of services.”⁵² The bill also makes certain conforming amendments.⁵³ However, the legislation does not specify whether this recharacterization affects only the conformed sections and section 1 or instead recharacterizes the income and gain for all purposes of the Code. If the recharacterization applies for all purposes, this may have a number of indirect consequences.

The application of certain provisions of the Code turn on the existence and/or quantum of a partner’s profits interest. For example, many sections of the Code turn on whether two parties are related, defining relationship by reference to a partner’s profits interest or to section 707(b) which, in part, utilizes a profits interest test. It is unclear whether a distributive share that is recharacterized by proposed section 710 is intended to be treated as an interest in profits for these purposes or, by virtue of the recharacterization, is separated from the partnership’s profits for such an analysis.

Other Code provisions rely upon a partner’s interest in an item of income. For purposes of these provisions, does the recharacterized income or gain constitute a new item of partnership income or gain or will it retain its character? For example, assume a partnership allocates its income 10 percent to the carried interests and 90 percent to the purchased interests and that the partnership has only capital gains. It may change the tax consequences to the carried interest partners and/or the purchased interest partners if the purchased interest partners have 100 percent of the capital gains and the carried interest partners have 100 percent of a new category of income, the ordinary income for the performance of services. It could affect, among other things, whether the allocations of the partnership satisfy the requirements of sections 168(h) or 514(c)(9)(E) and whether the *de minimis* exceptions of Treasury Regulation section 1.752-2(d) will apply.

Proposed section 710 may also have ramifications under the newly signed U.S.-Canada tax treaty protocol.⁵⁴ Under Article 2(2) of the protocol, a new paragraph 6 is added to Article IV of the U.S.-Canada treaty. The new paragraph 6 would treat an amount of income, profit or gain as derived by a person who is a resident of a Contracting State if two conditions are satisfied. First, the person must be treated as having derived the amount through an entity (other than an entity that is a resident of the other Contracting State) under the taxation law of the Contracting State. Second, the treatment of the amount under the taxation law must be the same as its treatment would have been

⁵² Proposed sections 710(a)(1)(A) and 710(b)(1).

⁵³ H.R. 2834 makes conforming amendments to sections 731, 741 and 1402 and to section 211 of the Social Security Act.

⁵⁴ Protocol Amending U.S.-Canada Convention on Income, Capital Taxes, Sept. 21, 2007. H.R. 2834 may have implications in other treaties if a similar character flow-through is required.

if that amount had been derived directly by the person in question. The interaction between section 710 and this second requirement may cause holders of “investment services partnership interests” to not qualify as residents under this tax treaty because the character of the income in the hands of the partnership will be different than the character of the income in the hands of the partner. We question whether this result is intended.

G. Interaction with Section 704(b)

A partner’s share of a partnership’s income, gain, loss, deduction, or credit will be determined in accordance with the partner’s interest in the partnership unless the partner’s share is allocated under a partnership agreement and unless such allocation has substantial economic effect. This rule, provided in section 704(b), has been implemented by Regulations that determine whether an allocation with economic effect has substantiality based upon the after-tax economic consequences to the partners.⁵⁵

The impact of H.R. 2834 on the substantiality determination is unclear. If the determination occurs before the income or gain is recharacterized by proposed section 710, the outcome of the determination might be quite different from the outcome if the determination is undertaken after the recharacterization of the income. If a service provider will have its income recharacterized as ordinary income, the other partners may desire to allocate ordinary income to the service provider (at least as to its carried interest) and allocate capital gains and/or tax-exempt income to the purchased interests. Whether this type of allocation would have substantial economic effect is not clear.

H. Interaction with Section 707(a)(2)(A)

Section 707(a)(1) generally provides that a transaction between a partner and a partnership will be treated as being between the partnership and one who is not a partner if the partner engages in the transaction in a capacity as other than a partner. Section 707(a)(2)(A) authorizes Treasury to promulgate Regulations to treat allocations and distributions related to services performed by a partner for a partnership as being under section 707(a)(1). This statute was enacted to prevent partners from converting ordinary income to capital gains and emulating a deduction that might otherwise be subject to capitalization or limitations on deductions.⁵⁶ However, no Regulations have been promulgated under this provision since its enactment in 1984.

Given the existence of section 707(a)(2)(A) for, it appears, the same tax policy underlying H.R. 2834, consideration should be given to the interaction between proposed section 710 and this existing statute. If the Congressional intent behind enacting H.R. 2834 is essentially the same as that behind section 707(a)(2)(A), Congress should provide clear direction as to the priority of these rules so that taxpayers and the Service

⁵⁵ See Treas. Reg. § 1.704-1(b)(2)(iii).

⁵⁶ H.R. Rep. No. 98-432, Part II, at 1218 (1984), reprinted in 1984 U.S.C.C.A.N. 697, 884.

will know whether an allocation with respect to an interest covered by H.R. 2834 should be recharacterized as compensation payments to an independent contractor or employee under section 707(a)(2)(A) or instead should be recharacterized as ordinary income under proposed section 710. It would appear that section 707(a)(2)(A) ought to be applied before proposed section 710 because, until section 707(a)(2)(A) is applied, the taxpayer will not know whether it has received an allocation and a related distribution or the payment of a fee. Of course, without guidance under section 707(a)(2)(A), it may be difficult to apply proposed section 710.

I. Interaction with Section 732(b)

The basis rules applicable to distributed property (other than money) may require coordination with the changes proposed to be made by H.R. 2834. Generally, the basis of property distributed in liquidation of a partner's interest in the partnership will be equal to the basis that partner had in its partnership interest under section 732(b). For example, assume that there is a partnership with two assets (A and B) and three partners (X, Y, and Z). Partners X and Y each contributed \$50 to partnership and partner Z received a profits interest (as defined in Revenue Procedure 93-27) entitled to one-third of the partnership's profits, which would be an "investment services partnership interest." Further assume that the partnership acquired asset A for \$25 and asset B for \$75, each to be held as capital assets. At a time when asset A has appreciated to \$250, the partnership distributes asset B to partner Z in complete liquidation of his interest. At the time of the distribution, the basis of asset B (a capital asset whose basis is equal to its fair market value) will be reduced to zero under section 732(b), and Z will hold asset B with a basis of \$0, meaning that the service provider (Z) will be able to sell that asset for a capital gain. Had the partnership sold all of its assets, the gain allocable to Z would have been recharacterized by the rules in H.R. 2834 as ordinary income.

Efforts to conform section 732(b) to the other provisions of H.R. 2834 will require consideration of partners that hold both purchased interests and carried interests. Such partners should be entitled to the capital gain that results to the extent the property was distributed with respect to the purchased interest.

J. Interaction with Section 751(b)

If a distribution is made to a partner and if, by virtue of that distribution, that partner either increases or decreases that partner's interest in certain ordinary or capital assets, section 751(b) may cause the transaction to be considered as a sale or exchange of such property between the recipient of the distribution and the partnership. The assets covered by section 751(b) are substantially appreciated inventory and unrealized

receivables, where “unrealized receivables” include (among other things) a right to payment for services rendered or to be rendered and depreciation or depletion recapture.⁵⁷

H.R. 2834’s differentiation as to carried interests and purchased interests may require special rules for the application of section 751(b). Specifically, proposed section 710 contains a rule that a disposition of the carried interest, including a distribution of money by the partnership to a partner in excess of the partner’s basis in the partnership, is considered ordinary income. Because of this special rule, it will most likely be necessary, when applying section 751(b), to treat the carried interest portion of a partnership interest as separate from the purchased interest portion of the same partnership interest. This is so because the partner will be treated as having ordinary income on the disposition of the carried interest regardless of the composition of the assets of the partnership. Because section 751(b) measures shifts in the partners’ shares of the ordinary income assets of the partnership, counting the carried interest in applying section 751(b) would not correctly measure the partners’ respective shares of the ordinary gain in the partnership’s assets. It may also be necessary to adjust the application of section 751(b) when applying it to the purchased interest portion of a partnership interest to take into account the fact that capital gain allocated to the service partner on the carried interest portion of the interest has been treated as ordinary income. Thus, the question arises as to whether the composition of the ordinary and capital assets of the partnership need to be adjusted when applying section 751(b) to the purchased interest or, alternatively, whether section 751(b) needs to be applied to the purchased interest without regard to the fact that capital gain allocated to the partner on the carried interest has been treated as ordinary income. Thus, consideration should be given to the rules that might be needed to allocate distributions to the purchased interest (as opposed to those made on the carried interest).

K. Interaction with Section 708(b)(1)(B)

As described above, H.R. 2834 appears to allow a loss from a particular partnership interest (which is covered by the bill) to offset prior income only from that interest. Section 708(b)(1)(B) provides that a partnership terminates if, within a 12-month period, there is a sale or exchange of 50 percent or more of the capital and profits interests in the partnership. Under Treasury Regulation section 1.708-1(b)(4), the terminated partnership is deemed for tax purposes to contribute all of its assets and liabilities to a new partnership and liquidate. This “technical termination” rule should be considered in light of the new loss limitation rule in H.R. 2834.

⁵⁷ The American Bar Association has recommended that Section 751(b) be amended by removing the substantial appreciation requirement in order to conform the tax treatment of transactions under Sections 751(a) and 751(b) and that all necessary technical and conforming changes to the Code be made. Policy of the ABA (adopted February 2003).

If a partner's distributive share in a partnership will be recharacterized as ordinary income under H.R. 2834 and if there is an intervening termination under section 708(b)(1)(B), the partner (who may or may not have transferred any portion of its interest in the partnership to trigger the termination and who may or may not have any control over whether the intervening termination occurred) should be allowed to utilize losses allocated to that partner after the termination from what, if no termination had occurred, is the same interest in the same partnership. Losses limited under sections 704(c)(1)(C), 704(d), 465 and 469 are generally thought to carry over despite a termination under 708(b)(1)(B). The same result appears appropriate here.

L. Interaction with Section 7704(b)

Section 7704 causes publicly traded partnerships to be treated as corporations unless the passive income exception applies. Specifically, section 7704(c)(2) requires 90 percent or more of a publicly traded partnership's income to be from "qualifying income." Qualifying income is defined in section 7704(d) to include, among other things, real property rents, gains from the sale or other disposition of real property and income and gain from certain activities (including exploring for, developing, producing and transporting commodities like oil, gas and timber).⁵⁸

In many publicly traded partnerships, the general partner is given certain "incentive distribution rights," which are special allocation and distribution rights that accrue if the general partner is able to manage the publicly traded partnership in a way that generates above targeted per unit distributions. These "incentive distribution rights" may well be carried interests that may, in certain circumstances, be covered by H.R. 2834.

The general partners of various publicly traded partnerships are themselves publicly traded partnerships that rely on the qualifying income character of the income that flows through to fit within the requirements of section 7704(c). H.R. 2834 refers, at times, to the income that it recharacterizes as "ordinary income for the performance of services." If a publicly traded partnership is a general partner of another publicly traded partnership, one consequence of the operation of H.R. 2834 may be to cause such general partner to be treated as a corporation, because what otherwise would be qualifying income under section 7704(c) would become (at least in part) nonqualifying compensation income under proposed section 710.

M. Application in Connection with Tiered Partnerships and Related Entities

In today's complex business environment, partnerships often own interests in other partnerships, which may in turn own interests in further lower tier partnerships. Service providers employed at, or that contract with, a lower tier partnership may be

⁵⁸ Qualifying income does not specifically include "income for the performance of services."

issued carried interests in an upper tier partnership. Likewise, service providers employed at or that contract with an upper tier partnership may be issued carried interests in a lower tier partnership. H.R. 2834 defines the carried interests to which it applies by whether the person provides “(directly or indirectly)” the covered services to the partnership in which the person holds the interest. This phrase may be designed to address tiered partnership situations, but the proposed legislation is not entirely clear.

Section 83 applies to any property transferred in connection with services, regardless of whether the property transferred is an interest in an entity for which (or for the benefit of which) services are provided. Thus, interests in partnerships might be issued to a person who provides services to entities owned by one or more partners in the partnership (or their affiliates). It is entirely possible that the taxpayer is providing the covered services, but not directly or indirectly to the partnership in which the taxpayer holds the interest.

Revenue Procedure 93-27 addresses interests received for services provided “to or for the benefit of” the partnership that issues the profits interests. If such services are the covered services, H.R. 2834 would appear to apply to the issued interest (as service performed “to” the partnership would likely be services provided “directly” to the partnership and services performed “for the benefit of” the partnership would appear to be services provided “indirectly” to the partnership). However, the intended meaning of “directly or indirectly” is unclear and should be clarified

N. Impact on Partners Not Holding “Investment Services Partnership Interests”

The apparent purpose of H.R. 2834 is to cause partners holding “investment services partnership interests” to pay ordinary income tax rates (as well as self employment and social security taxes) on their income associated with such interests. By recharacterizing the income after it has been allocated to such partners, there may have been an intent to limit the impact of the legislation on the other partners (“Non-ISP Partners”) of partnerships that have partners holding “investment services partnership interests.” However, as discussed below, Non-ISP Partners will face significant issues if this legislation is enacted.

1. Distortions Created by Not Allowing a Deduction

H.R. 2834 provides that gain will be recognized on distributions of appreciated property with respect to a carried interest.⁵⁹ This gain would be recognized as if the partnership sold the distributed property at fair market value at the time of the distribution.⁶⁰ Further, the disposition gain recognized by a holder of a carried interest is

⁵⁹ Proposed section 710(b)(4).

⁶⁰ It is unclear to whom the property would be treated as sold. If it were treated as sold to the partner, the sale might implicate certain other provisions of the Code, such as section 1239.

recharacterized as ordinary income.⁶¹ However, no deduction is allowed as to any of these income inclusions.

The lack of a deduction may result in distortions for the Non-ISP Partners. As an example, assume that a partnership has multiple Non-ISP Partners and one partner holding only a carried interest (entitled to 10 percent of the profits of the partnership) that is subject to H.R. 2834. Further assume that the partnership has a variety of assets, each of which has a fair market value equal to its basis and a single marketable security with a fair market value of \$100 and a basis of \$0. If the marketable security is distributed to the carried interest partner with respect to the carried interest, the partnership will recognize \$100 of gain, allocating \$10 to the carried interest partner and \$90 to the other partners. If the carried interest partner has a \$0 basis in its carried interest before that allocation (and \$10 thereafter), the carried interest partner will recognize \$90 of additional gain under section 731 upon receipt of the security.⁶² Thus, the carried interest partner will have recognized \$100 of ordinary income under H.R. 2834. The Non-ISP Partners will have recognized \$90 of capital gain and will have an aggregate outside basis that is \$90 in excess of their collective inside basis. The Non-ISP Partners would appear to have this basis disparity until the partnership is liquidated.⁶³ Such inside/outside basis disparities have been the source of aggressive tax planning in the past and could lead to aggressive tax planning by the Non-ISP Partners in the future.⁶⁴

Most payments for services have an associated compensation deduction.⁶⁵ If the deduction is not capitalized, the service recipient (or, in a partnership, the partners) may be subject to a variety of limitations on the use of that deduction, including sections 704(d), 465, 469, and 470 (discussed above). Other limitations can also apply, such as sections 67 and 68. The application of the recharacterization of distributive share by H.R. 2834 as a means of taxing services income could result in the Non-ISP Partners not being subject to these deduction limitations, to the extent that they otherwise would have been. For some taxpayers, this will result in less tax being paid (compared with utilizing another method for compensating the service provider) and, for others, it will result in more tax being paid.

⁶¹ Proposed section 710(b)(1).

⁶² This assumes that section 731(c) would apply to the \$90 of excess securities value that is distributed to the partner. Thus, the interaction of section 731(c) with proposed section 710 should be clarified if the legislation is enacted.

⁶³ Section 731(c)(5) states that section 731(c) is disregarded in applying the rules of sections 733 and 734(b).

⁶⁴ For example, aggressive tax planning led Congress to enact sections 734(d) and 743(d).

⁶⁵ This deduction may be currently deductible or, in certain circumstances, the service recipient may be required to capitalize the expense.

2. Issues for Partnerships that Hold “Investment Services Partnership Interests”

As discussed above, many partnerships own interests in other lower-tier partnerships. If an upper-tier partnership provides the services described in H.R. 2834, interests in the upper-tier partnership would apparently become subject to the operation of that bill. The upper-tier partnership’s distributive share of income from the lower-tier partnership would be recharacterized as ordinary income for the performance of services. The distributive share of the upper-tier partnership would have the same character when allocated to the partners of the upper-tier partnership.⁶⁶

The recharacterization may affect Non-ISP Partners of the upper-tier partnership in a variety of ways. For example, the Non-ISP Partners who have such status because they are not providing the covered services will have ordinary income instead of capital gain or tax-exempt income despite having not provided the covered services. Additionally, foreign Non-ISP Partners may be drawn into the U.S. tax system and have a U.S. trade or business by virtue of the allocation of services income (which, before the application of H.R. 2834, may have been exempt from U.S. taxation as, for example, portfolio interest or capital gain). Tax-exempt Non-ISP Partners will experience the recharacterization of income from what may not have been unrelated business taxable income (*e.g.*, interest, dividends, or capital gains) to income that is subject to the unrelated business income tax.

⁶⁶ Section 702(b).