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TAXATION
A Section of the American Bar Association

November 5, 2010

The Honorable Max S. Baucus
Chairman
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Sander M. Levin
Chairman
United States House of Representatives
Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Charles E. Grassley
Ranking Member
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Dave Camp
Ranking Member
United States House of Representatives
Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

Re: Comments on Carried Interest Proposals in Senate Amendment 4386 to H.R. 4213

Gentlemen:

These comments ("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.

The Section of Taxation submitted comments in November 2007[1] and May 2010[2] concerning prior versions of proposals to alter the taxation of "carried interests." These comments address issues with regard to the proposal in Senate Amendment 4386, which was introduced on June 23, 2010, by Senate Majority Leader Reid for Chairman Baucus, to amend the American Jobs and Closing Tax Loopholes Act of 2010 to alter the taxation of certain carried interests by adding a new section 710 to the Internal Revenue Code ("Proposed Section 710").[3] In particular, these Comments focus on those aspects of Proposed Section 710 that we believe would require changes to the proposed statutory language. Notwithstanding various provisions in Proposed Section 710 that would provide the Secretary of the Treasury Department with significant latitude to promulgate regulations with respect to Proposed Section 710, we believe the text of Proposed Section 710 and the Congressional intent

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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] ABA Section of Taxation, "Update of ABA Section of Taxation Comments on H.R. 2834 with respect to H.R. 4213" (May 11, 2010), *available at* http://www.abanet.org/tax/pubpolicy/2010/051110commentsHR4213.pdf.

[3] S. Amend. 4386, § 412,156 Cong. Rec. S5324, S5344-47 (daily ed. June 23, 2010). On July 22, 2010, H.R. 4213, Unemployment Compensation Extension Act of 2010, Pub. Law 111–205, 124 Stat. 2236, was enacted into law. As enacted, H.R. 4213 did not include any provisions affecting the taxation of carried interests. On September 16, 2010, Chairman Baucus introduced S. 3793, Job Creation and Tax Cuts Act of 2010, which includes a proposal with respect to the taxation of carried interests that appears to be identical to Proposed Section 710 (as defined above).

underlying that text would constrain the Secretary's regulatory authority. Thus, we respectfully request that the statutory language of Proposed Section 710 be modified to address the issues raised in these Comments.

In addition, as we have stated in our prior comments, we believe Proposed Section 710 would add significant and burdensome complexities to the Code and alter fundamental principles of partnership taxation. For those reasons, we continue to believe that Proposed Section 710 should be reconsidered.

Proposed Section 710 would recharacterize income allocations of an investment service partnership from capital gain to ordinary income and defer losses allocated by such a partnership. These new provisions would apply to a partner providing investment services to the partnership. The service partner's interest would be defined as an investment services partnership interest ("ISPI"). Proposed Section 710 also would change the taxation of distributions by the partnership on ISPIs and dispositions of ISPIs. In addition, Proposed Section 710 would further add penalties with respect to disqualified interests and impose self-employment tax with respect to ISPIs.

The issues for which we believe the statutory language of Proposed Section 710 should be modified fall into two categories: (1) the scope of Proposed Section 710, and (2) qualified capital interests. We address each category in turn.

Issues Regarding the Scope of Proposed Section 710

- We understand that the original purpose of Proposed Section 710 was to tax the compensation element of a carried interest granted to fund managers as ordinary income. We believe Proposed Section 710 goes beyond that original purpose in several ways. For example, if the intent of the legislation is to convert capital gains to ordinary income, it is unclear why Proposed Section 710 provides loss deferral and mandatory gain recognition for C corporations, which are not taxed at different rates on capital gains or ordinary income.

- Given the burden of understanding and complying with the complex rules under Proposed Section 710, we urge the Congress to consider adding provisions to exempt small businesses.

- Consistent with our understanding of the original purpose of Proposed Section 710, we are concerned with the apparent application of Proposed Section 710 to non-grantor trusts and to decedents' estates, which could accede to ownership of an ISPI that was previously owned by an individual through transfers that are not inherently abusive (e.g., gifts, sales, and bequests) and which are generally subject to the same rates as individuals. Specifically, Proposed Section 710(g) does not appear to apply to non-grantor trusts and estates. We believe that the rules applicable to individuals should also be applicable to trusts and estates.

- Proposed Section 710 describes specific categories of assets as "specified assets." Proposed Section 710 would treat all partnership interests held by a partnership as "specified assets" regardless of the underlying character of the lower tier partnership's assets. We are not aware of any significant policy rationale for including all partnership interests (especially those issued by partnerships with no real estate, securities, commodities or derivatives, such as operating small grocery businesses).[4] If the intent is to prevent taxpayers from circumventing Proposed Section 710 by forming partnerships to hold real estate, securities, commodities or derivatives, we believe this could be addressed in a manner similar to the approach used in section 731(c)(2)(B)(v) and (vi),[5] which treat partnerships holding specified assets in a manner similar to the manner in which those assets would be treated (*i.e.*, a look-through analysis) without causing all partnership interests to be treated as the specified "bad" assets.[6]

- Under Proposed Section 710, an interest that was an ISPI when it was acquired or that later became an ISPI would always be treated as an ISPI. Proposed Section 710 does not include any provision that would allow an ISPI to become an interest that is not an ISPI, even if services were never provided or were provided briefly or long ago.

- Proposed Section 710(e) appears to be directed at preventing the use of other entities or vehicles to avoid the application of Proposed Section 710. However, there is no indication in Proposed Section 710(e) that an avoidance or abusive intent is required.

Issues Regarding Qualified Capital Interests

- The Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in the "American Jobs and Closing Tax Loopholes Act of 2010," for consideration on the floor of the House of Representatives,[7] provides that a transferee partner "accedes to the amount of the qualified capital account of the transferor partner."[8] Proposed Section 710 would provide qualified capital only for (i) contributions of money or other property, (ii) gross income recognized under section 83 and (iii) undistributed net income from the partnership interest. Therefore, under the plain language of Proposed Section 710, a transferee who has neither contributed money or other property, had any gross income under section 83 nor yet been allocated any income would not have any qualified capital with respect to the transferred interest. We believe the statutory language should expressly state that qualified capital as to a purchased partnership interest includes either the purchase price for the interest or the capital account of the transferee.

- If all qualified capital, such as capital contributions and distributive shares with respect to qualified capital, has been distributed, then the partners would have zero or

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[4] Neither these Comments nor our prior comments directly consider the policy behind the asset classes specified in Proposed Section 710 or prior versions of the proposed statutory changes with respect to the taxation of carried interests.

[5] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

[6] In effect, Proposed Section 710 would subject all tiered partnership structures to its provisions, which we believe would harm legitimate business planning without accomplishing the apparent policy goals of the Congress. Subjecting all tiered partnership structures does not directly cause fund managers to pay ordinary income tax and self-employment tax on income attributable to managing investor funds but rather will cause taxpayers generally to be subject to Proposed Section 710 merely because they utilized tiered partnership structures.

[7] (JCX-29-10), May 28, 2010.

[8] *Id*. at 274.

negative capital account balances and none of the partners (those holding ISPIs and non-service partners) would have any qualified capital with respect to which qualifying allocations could be made. It appears, however, that future allocations and distributions that are made in accordance with the partners' qualified capital (before the distributions described in the preceding sentence) should not be subject to Proposed Section 710(a) and (b) because these allocations and distributions would not represent a "carried interest" but, rather, are still being made with respect to qualified capital. We believe the statutory language should confirm that Proposed Section 710(a) and (b) would not apply to future allocations and distributions made in accordance with such pre-distribution qualified capital.

- Taxpayers would not have a "qualified capital interest" for value in a partnership if investors are later joining the partnership and the partnership will make allocations of income disproportionately to one or more ISPI owners that always had proportionate capital before the investment. For example, assume A and B form a partnership by each contributing $100 of cash, the partnership acquires real estate for rental or investment, and B provides services with respect to the real estate. Later, when the property has appreciated to $500, C joins the partnership by contributing $250 in cash for a one-third interest and the one-half interests previously held by A and B become one-third interests. We believe policy supports B having a qualified capital interest of $250 (rather than merely having qualified capital equal to the original contribution of $100). Similarly, an ISPI owner in a partnership in existence upon the effective date of the legislation would not receive any credit toward the owner's qualified capital interest for value that exists when the legislation becomes effective. The value in a partnership at any such time is economically indistinguishable from value held outside the partnership that a partner could contribute in exchange for qualified capital. We therefore believe that Proposed Section 710 should treat pre-existing value as qualified capital.

- Proposed Section 710(d)(7)(A)(i) provides that qualified capital is determined without regard to section 752(a), but Proposed Section 710(d)(7)(B)(i) would not similarly eliminate consideration of section 752(b). Section 752(a) provides that a partner is deemed to make a contribution of money if that partner's share of partnership liabilities increases, and section 752(b) provides that a partner is deemed to receive a distribution of money if that partner's share of partnership liabilities decreases. We recommend making these provisions consistent so that qualified capital is either determined *without* regard to both section 752(a) and 752(b) *or* determined *with* regard to both of those provisions.

- The title of Proposed Section 710(d)(6) (which reads "Special Rule for Dispositions") suggests that this provision applies only to dispositions. However, the statutory language of Proposed Section 710(d)(6) would cause all of Proposed Section 710(b) not to apply to the extent provided in Proposed Section 710(d)(6). Proposed Section 710(b) addresses distributions, as well as dispositions. Thus, the title of Proposed Section 710(d)(6) may create ambiguity. We recommend revising the title to reflect the full scope of the statutory language.

As mentioned above, as is often the case with tax legislation, we are concerned that if enacted, Proposed Section 710 would significantly increase the complexity of the tax system and thereby impose additional compliance burdens on both the Internal Revenue Service and taxpayers. We urge careful consideration of the complexity that Proposed Section 710 would add to the tax system as the merits of Proposed Section 710 or any other proposed legislation with regard to the taxation of carried interests are considered.

We appreciate your consideration of these Comments. Representatives of the Section would be pleased to discuss these Comments with you or your respective staffs. Please contact Helen M. Hubbard, the Section's Vice Chair for Government Relations, at (202) 528-5217 to arrange for a discussion.

Sincerely,

Charles H. Egerton
Chair, Section of Taxation

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