Carried Interests

Real Property Trust and Estate Section of the ABA – Spring Symposia

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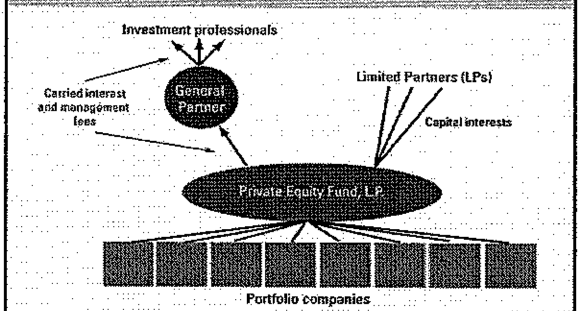
Carried Interest

- A "carried interest" is a right that entitles the general partner (GP) of a public or private investment fund to a share of the fund's profits or capital as compensation for managing the fund's assets. The interest may be vested or unvested.
- **Example:** GP contributes 1% of a fund's initial capital and agrees to manage the fund for a fee of 2% of the fund's assets, plus a carried interest of 20% of the fund's profits that exceed a certain hurdle rate.

Figure 1. Fund Structure



Source: Adapted by author from Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, NYU Law Review (forthcoming, 2008).

Carried, Profits, or Promoted Interest

- Carried interests are also called profits or promoted interests. Regardless of the term used, it represents the interest given to a GP by the partnership in the potential appreciation of the project.
- The carried interest gives the GP a stake in the venture's ultimate success, while also compensating the GP for his or her risks *(e.g.* environmental contamination, lawsuits, and debts of the partnership).

Why "Carried Interests" Attracted Legislators Interest

- Private equity and hedge funds currently manage about $2 trillion in assets.
- "Carried interests" constitute about one-third of the GP's total compensation for managing these funds.
- While management fees are taxed as ordinary compensation income, carried interests are taxed at capital gains rates and exempt from employment tax.
- Thus, the GP receives income for services rendered at capital gain rates rather than ordinary income rates.

Legislative Background

- In 2007, Rep. Sandy Levin (D-MI) introduced H.R. 2834 taxing "carried interests" as ordinary income regardless of their character at the partnership level.
- Several similar proposals followed over the next two years with Levin's 2007 Bill used as a model
- In April 2009, Rep. Levin re-introduced a bill, H.R. 1935, to tax carried interest at ordinary income rates, which encompassed some of his 2007 proposals.

Legislative Background (cont.)

- On December 9, 2009, the House passed the Tax Extenders Act of 2009 (H.R. 4213). The Bill extends certain expiring tax provisions and includes a provision to tax carried interests similar to Levin's 2009 bill to help pay for the extenders.
- The Administration's Fiscal Year 2010-2011 Revenue Proposals contained a provision to tax carried interests.

The Tax Extenders Bill, H.R. 4213

- The Joint Committee on Tax estimated the revenue effect of taxing carried interests at $24 billion over a 10 year period. *JCX-59-09 p.5.*
- According to the Administration's 2011 Greenbook Explanation, the carried interest provision will eliminate an "unfair and inefficient tax preference" for "some of the highest-income Americans."
- The Senate has not passed the House Extenders Bill or any other proposal to tax carried interests.

The Tax Extenders Bill, H.R. 4213

- Amends IRC § 83 to tax the receipt of a partnership interest for services rendered at its liquidation value in the year of receipt, unless the partner elects to defer recognition until the interest is vested.
- Adds a new IRC § 710 re-characterizing the taxation of "carried interests" as ordinary income effective for tax years ending after 12/31/2009. It has no grandfather rules.
- Amends §1402 subjecting income from carried interests to self-employment tax.

WHO IS AFFECTED?

- The legislation is directed at managers of hedge funds and private equity funds that operate as partnerships.
- However, it will have an unintended impact on many partnership activities not related to hedge funds and private equity funds.
- It will affect every person who takes a share of an investment fund's profits as compensation.

IRC § 83

- § 83 currently provides that property received for services is taxed as ordinary income at its FMV on the earlier of a) when the property becomes transferable or b) is no longer subject to a substantial risk of forfeiture.
- The service provider can make a § 83(b) election to recognize income when the property is received. This starts the basis and holding period for the property and converts future appreciation to capital gain.
- § 83 is silent with respect to "carried interests."

IRC § 83 GUIDANCE

- Rev. Proc. 93-27 and 2001-43- A partnership profits interest for services is not a taxable as long as the person receives the interest either as a partner or in anticipation of becoming one. No Section 83(b) election is necessary. The receipt of a capital interest is taxable.
- Prop. Reg. §1.83-3 – A partnership profits or capital interest for services is taxable under § 83. The regulations describe the rules for vesting and forfeiture of partnership interests.
- Notice 2005-43 – provides a liquidation value safe harbor for valuing a partnership interest for services.

PROPOSED CHANGES TO § 83

- The Extenders Bill adds a new provision in § 83 to tax the receipt of a partnership interest for services at its liquidation value in the year of receipt.
- Liquidation value is defined as the distribution a partner would receive if the partnership sold all of its assets and distributed the proceeds net of liabilities to its partners in liquidation.
- The service provider would be treated as having made a §83(b) election, immediately recognizing income equal to the liquidation value less the amount paid for the interest, unless he elects out.
- If the carried interest is forfeited, no loss is allowed for the income previously reported under § 83.

NEW IRC § 710 - DEFINITIONS

- **Investment Services Partnership Interest (ISPI)** - an interest in the partnership attributable to services rendered with respect to Specified Assets.
- **Qualified Capital Interest** - a partnership interest attributed to capital actually contributed as opposed to services rendered.
- **Specified Assets** - securities, real estate held for rental or investment, interests in partnerships, commodities, or options or derivative contracts with respect to these assets.

INVESTMENT SERVICES PARTNERSHIP INTEREST ("ISPI")

- All net income attributable to an ISPI is characterized as ordinary income and all net losses are characterized as ordinary losses regardless of their actual character.
- All excess ISPI losses are required to be carried forward.
- Any gain or loss from a disposition of an ISPI is characterized as ordinary income or loss.
- All income and losses are subject to SE tax.

QUALIFIED CAPITAL INTERESTS

- A partner's interest in the capital of the partnership that is attributable to:
  - (1) the FMV of any money or other property contributed to the partnership in exchange for the capital interest;
  - (2) amounts that have been included in gross income under § 83 with respect to the transfer of the interests; and
  - (3) the excess of income and gains over losses and deductions with respect to the interest.

QUALIFIED CAPITAL INTERESTS (CONT.)

- Income and losses attributable to a qualified capital interest are not re-characterized as long as the allocations made to it are made in the same manner as made to other qualified capital interests held by partners who DO NOT provide services and who are unrelated to the service partner AND the allocations are significant.

SPECIAL RULE WHERE NO UNRELATED NON-SERVICE PARTNERS

- **Example:** Joe purchased a 25% interest in Acme Ventures, Ltd. paying the same price as all the other limited partners. He is also the GP for which he receives a 20% profits interest after the limited partners get twice their money back. All partners provide investment services to the partnership.
- The Bill authorizes the IRS to issue regulations or other guidance so that Joe's 25% capital interest is not re-characterized as compensation income.

Penalties

- The Bill amends § 6662 to apply a 40% penalty to any portion of an underpayment attributable to § 710.

Why Change the Tax Treatment of Carried Interests?

- Revenue raiser - low hanging fruit.
- Basic principle is that compensation for services (*especially by some of America's highest paid promoters*) should be treated as ordinary income regardless of its source.
- Service partners have no downside risk compared to investors or other business owners who could lose their entire invested capital.

Arguments Against the Proposal

- The amount of capital available for these types of investments may be reduced.
- Fund managers will charge higher fees to compensate for their higher taxes.
- Taxing carried interests will inadvertently hurt:
  - family partnerships,
  - pension funds investors, and
  - real estate partnerships.

ARGUMENT AGAINST (CONT.)

- Start up ventures in technology, natural resources, and other areas will be negatively impacted by this Bill.
- A "carried interest" is merely a way to divide the profits of a partnership between the partners who provide the capital and those who provide the idea and the sweat. There is no reason capital gains cannot be one of the rewards for services rendered, similar to a business owner who starts his own business. He may not have much capital invested, but he has his blood, sweat and tears.

AND MORE ARGUMENTS AGAINST...

- The Legislation goes against the "core" principles of how Subchapter K allocates partnership items. Under new § 710, the concept of a partnership as a "flow through entity" is completed gutted.
- Adds complexity to tax reporting and may result in extensive modifications to the Code.

UNANSWERED QUESTIONS

- Can guaranteed payments for future profits be considered a carried interest?
- Are investment services partnership interests ("ISPI") entitled to an adjusted basis on the death of a service partner under §1014 despite the no basis adjustment rule in § 710(a)(2)(C)?

BREADTH OF CODE §710

- The proposed legislation will have an unintended adverse impact on partnerships and industries not associated with investment funds.
- § 710 authorizes the IRS to write legislative regulations implementing its provisions. Thus, they will be Chevron regulations with the force and effect of law, and will be virtually unchallengeable.