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ALERT

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Comprehensive Tax Reform Puts Carried Interest Back on the Table

On February 26, 2014, House Ways and Means Committee Chairman Dave Camp (R-Mich.) introduced a discussion draft of the Tax Reform Act of 2014 (the Act) as an attempt to move forward with the most comprehensive revision of the Internal Revenue Code (the Code) since 1986. Many commentators are highly skeptical that the Act will be passed by Congress, either in its current form or even with substantial modifications. Nevertheless, some commentators have noted that the Act represents an important starting point for continued debate on tax reform, and may include certain proposals that could be enacted as drafted.

Among the numerous changes that the Act would make to the Code is the taxation of carried interest received by a service partner in connection with its performance of services for a partnership making investments in businesses. As described in more detail below, the Act would recharacterize a portion of any capital gain recognized with respect to the service provider's partnership interest as ordinary income. The House Ways and Means Committee summary of the Act states that the Act is intended to approximate the compensation earned by the service provider for managing the capital of the partnership. Accordingly, the proposal would seem to treat the service partner as borrowing from the limited partners an amount equal to the partnership capital that is used to fund the service partner's share of any partnership profit, such that a stated interest rate would be imputed based upon the borrowed capital, and the interest that is deemed accrued would establish the amount of partnership income allocated to the service partner that would be treated as ordinary income. In this respect, Camp's proposal differs significantly from previous Congressional proposals to tax carried interest as ordinary income. The previous proposals generally taxed any income allocated to a service partner as ordinary income (unless the service partner could show that a portion of the partner's return was attributable to the partner's invested capital).

The House Ways and Means Committee asserts directly in its summary of the Act that "a partnership (e.g., private equity fund) that is in the business of raising capital, investing in other businesses, developing such businesses, and ultimately selling them, is in *the trade or business of selling businesses*." (emphasis added) The summary also refers to such a fund's portfolio companies as "inventory." Perhaps unsurprisingly, neither the summary nor the Act itself addresses the wide-ranging implications of such concepts if they were applied to private equity funds and similar investment partnerships for purposes of other sections of the Code more generally. However, the summary does state that the Joint Committee on Taxation estimates that this carried interest provision would increase revenues by $3.1 billion through 2023.

Specifically, the Act would apply to any partnership that is in a "trade or business" conducted on a regular, continuous and substantial basis and consisting of (i) raising or returning capital, (ii) investing in (or disposing of) trades or businesses (or identifying trades or businesses for such investing or disposition) and (iii) developing such trades or businesses.

The Act would create a complex formula pursuant to which a service partner's capital gains are treated as ordinary income only to the extent of the balance in the partner's "recharacterization account balance" for any particular taxable year. Under the proposal, a partner's recharacterization account balance for a taxable year is equal to (i) the partner's "annual recharacterization amount" for the current taxable year plus the recharacterization account balance carried forward from the prior year over (ii) the net ordinary income allocated with respect to the partner's interest for the current year plus the amount recharacterized as ordinary income in the preceding year. The annual recharacterization amount equals the product of (i) the long-term applicable federal rate (AFR) for the last month of the calendar year plus 10 percentage points and (ii) (a) the highest percentage of partnership profits that could be allocated to the partner for the taxable year multiplied by the partnership's aggregate invested capital, reduced by (b) the "specified capital contribution" (i.e., the average daily amount of the partner's contributed capital for the taxable year) of the service partner.

In a colloquial sense, the idea seems to be that a carried interest represents bonus compensation for services (ordinary income) to the extent of a return (i.e., AFR plus 10%) on the share of the aggregate capital investment in the partnership that is supporting the carried interest. That is, for the service provider's services in enhancing the capital value, the productivity of a share of the invested capital is set aside for his benefit (the carried interest). The actual return on this share, up to a limit, represents the value of such services. For example, if the carried interest is 20%, the share of aggregate capital investment in the partnership that is supporting that carried interest is also 20%. That amount of invested capital ought to produce a return to the service partner, treated as ordinary income, of at least the AFR plus 10% (or less, if the total return on that amount of capital is less).

As a simplified illustration, if the Act applied to an investment partnership with total contributed capital of $100 million, and the general partner did not contribute any capital to the partnership, but was entitled to a 20% carried interest after recoupment of the limited partners' capital contributions, the general partner's recharacterization account balance in the partnership's first taxable year would be calculated as follows, assuming a long-term AFR of 3.32%:13.32% multiplied by $20 million (.20 x $100 million). As a result, the service partner's recharacterization account balance at the end of the year would equal $2,664,000. In other words, up to $2,664,000 of the general partner's gain recognized from the partnership otherwise treated as capital gain would be recharacterized as ordinary income. If at the beginning of the next year, the fund sold its investment for $150 million, of which the general partner received $10 million (20% of the $50 million balance remaining after return of the investors' capital),

$2,664,000 of its gain would be ordinary income, and the $7,336,000 balance would be capital gain, as under present law.

This rule would apply to capital gain allocated to the service partner as well as to partnership distributions and dispositions of partnership interests (including dispositions of partnership interests in transactions that otherwise would qualify for non-recognition treatment under the Code). Importantly, the summary of the Act states that these provisions would not apply to any partnership engaged in a real property trade or business, but there is no indication as to how taxpayers would determine whether a partnership has sufficient real property investments to avoid the application of this rule. The Act also requires the partnership to annually furnish to each partner the amount of the partner's annual recharacterization amount. If enacted, the changes made by the Act to the taxation of carried interest would be effective for taxable years beginning after December 31, 2014.

The summary to the Act claims that the provision is designed "to clarify a murky area of the tax law" without acknowledging that private equity funds and similar investment partnerships of wide-ranging sizes and scope have relied on the clear and consistent current law regarding the taxation of carried interest for decades.

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