

Ending the Carried Interest Loophole Act

Detailed Summary

Current law:

Partnership profits interest for services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership (sometimes referred to as a carried interest) in exchange for the performance of services has been the subject of controversy. Though courts have differed, in some instances, a taxpayer receiving a profits interest for performing services has not been taxed upon the receipt of the partnership interest.

In 1993, the IRS, referring to the litigation of the tax treatment of receiving a partnership profits interest and the results in the cases, issued administrative guidance that the IRS generally would treat the receipt of a partnership profits interest for services as not a taxable event for the partnership or the partner.¹ Under this guidance, this treatment does not apply, however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. More recent administrative guidance² clarifies that this treatment applies with respect to a substantially unvested profits interest provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.³

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating to the receipt of property for the performance of services.⁴ A partnership capital interest for this purpose is an interest that would entitle the receiving partner to a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in liquidation.⁵

Property received for services under section 83

In general

Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with

¹ Rev. Proc. 93-27 (1993-2 C.B. 343).

² Rev. Proc. 2001-43 (2001-2 C.B. 191). This result applies under the guidance even if the interest is substantially nonvested on the date of grant.

³ A similar result would occur under the "safe harbor" election under proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005).

⁴ Secs. 61 and 83; Treas. Reg. sec. 1.721-1(b)(1); see U.S. v. Frazell, 335 F.2d 487 (5th Cir. 1964), cert. denied, 380 U.S. 961 (1965).

⁵ Rev. Proc. 93-27, 1993-2 C.B. 343.

the performance of services, the person performing the services (the “service provider”) generally must recognize income for the taxable year in which the property is first substantially vested (i.e., transferable or not subject to a substantial risk of forfeiture).⁶ The amount includible in the service provider’s income is the excess of the fair market value of the property over the amount (if any) paid for the property. A deduction is allowed to the person for whom such services are performed (the “service recipient”) equal to the amount included in gross income by the service provider.⁷ The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which the amount is included in the service provider’s income.

Property that is subject to a substantial risk of forfeiture and that is not transferable is generally referred to as “substantially nonvested.” Property is subject to a substantial risk of forfeiture if the individual’s right to the property is conditioned on the future performance (or refraining from performance) of substantial services. In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services, provided that the condition relates to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur.

Section 83(b) election

Under section 83(b), even if the property is substantially nonvested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. Such an election is referred to as a “section 83(b) election.” The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

Section 1061

In 2017, P.L. 115-97 enacted section 1061 providing for the recharacterization of certain gains in the case of partnership profits interests held in connection with the performance of services. The provision provides for a three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership interest held by the taxpayer.

⁶ The Department of Treasury has issued proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. 70 Fed. Reg. 29675 (May 24, 2005). The proposed regulations provide that a partnership interest is “property” for purposes of section 83. Thus, a compensatory transfer of a partnership interest is includible in the service provider’s gross income at the time that it first becomes substantially vested (or, in the case of a substantially nonvested partnership interest, at the time of grant if a section 83(b) election is made). However, because the fair market value of a compensatory partnership interest is often difficult to determine, the proposed regulations also permit a partnership and a partner to elect a safe harbor under which the fair market value of a compensatory partnership interest is treated as being equal to the liquidation value of that interest. Therefore, in the case of a true profits interest in a partnership (one under which the partner would be entitled to nothing if the partnership were liquidated immediately following the grant), under the proposed regulations, the grant of a substantially vested profits interest (or, if a section 83(b) election is made, the grant of a substantially nonvested profits interest) results in no income inclusion under section 83 because the fair market value of the property received by the service provider is zero. The proposed safe harbor is subject to a number of conditions. For example, the election cannot be made retroactively and must apply to all compensatory partnership transfers that occur during the period that the election is in effect.

⁷ Sec. 83(h).

The provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies.

In general, an applicable partnership interest is any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of services in any applicable trade or business. The services may be performed by the taxpayer or by any other related person or persons in any applicable trade or business.

An applicable trade or business means any activity (regardless of whether the activity is conducted in one or more entities) that consists in whole or in part of the following: (1) raising or returning capital, and either (2) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition), or (3) developing specified assets.

Ending the Carried Interest Loophole Act:

In general

The bill provides that a taxpayer holding an applicable partnership interest is treated as recognizing ordinary income equal to the partner's deemed compensation amount. A taxpayer with a deemed compensation amount is concurrently treated as realizing a capital loss in equivalent amount.

The bill applies to partners of a partnership in which a taxpayer holds one or more applicable partnership interests at any time during the taxable year. The deemed compensation amount is calculated and recognized annually based on a specified rate of return on an applicable percentage of the invested capital of all partners over the partner's share of invested capital.

The bill amends section 83 to value at issuance a compensatory partnership interest based on its liquidation value. An amount included in income upon acquisition of the applicable partnership interest under section 83 with respect to such applicable partnership interest does not prevent application of this provision. However, a section 83 inclusion is included in a partner's share of invested capital and would therefore serve to reduce a partner's deemed compensation amount.

Rev. Procs. 93-27 and 2001-43 will not apply to the transfer of a partnership interest to which this provision applies.

Amendments to, and interaction with, section 83

The bill amends section 83 by: (1) requiring that a compensatory partnership interest be valued based on its liquidation value; (2) effectively treating a section 83(b) election as having been made in the case of a transfer of a compensatory partnership interest unless the recipient elects otherwise; and, (3) treating amounts included in gross income under section 83 as additions to the partner's capital account for purposes of Subchapter K and as additions to invested capital for purposes section 1299, as applicable.

The Secretary is given authority to provide for circumstances, if any, in which additions to partner's capital and invested capital is not appropriate.

Applicable partnership interest

An applicable partnership interest is any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of services in any applicable trade or business. The services may be performed by the taxpayer or by any other person or persons in any applicable trade or business. It is intended that partnership interests shall not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership or included an amount under section 83 at issuance of such interest.

An applicable partnership interest includes any interest in a partnership acquired by a taxpayer by contribution of cash or other property if such cash or property was obtained by the partner from an applicable loan from the partnership or any other partner of the partnership, or any person related to such other partner or such partnership.

An applicable partnership interest includes any applicable financial instrument or contract the value of which is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations). An exception is provided for non-convertible debt instruments treated as debt for Federal tax purposes.

Applicable trade or business

An applicable trade or business means any activity (regardless of whether the activity is conducted in one or more entities) that consists in whole or in part of the following: raising or returning capital, and either (1) investing in (including acquiring or disposing of) specified assets (or identifying specified assets for such investment, acquisition, or disposition), or (2) developing specified assets.

Developing specified assets takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of a service provider. Services performed as an employee of an applicable trade or business are treated as performed in an applicable trade or business for purposes of this rule. Merely voting shares owned or exercising the right to vote with respect to shares owned does not amount to development; for example, a mutual fund that merely votes proxies received with respect to shares of stock it holds is not engaged in development.

Specified assets

Under the provision, specified assets means securities (generally as defined under rules for mark-to-market accounting for securities dealers with certain modifications), commodities (generally as defined under rules for mark-to-market accounting for commodities dealers with certain modifications), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to the foregoing, as well as an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.

A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a partnership (regardless of whether such partnership interest is widely held or publicly traded) or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any

such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified.

A commodity for this purpose means any (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity or notional principal contract, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified. An exception is provided for commodities held in connection with the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities.

Applicable loan

An applicable loan is any loan other than a loan which: (1) is fully recourse to the borrower or fully secured by the borrower's assets and (2) requires payments of interest with a stated rate not less than the specified rate.

Deemed compensation amount

The deemed compensation amount with respect to any applicable partnership interest for any partnership taxable year is the product of the specified rate multiplied by an amount equal to the applicable percentage of the weighted average of invested capital of all partners of the partnership over the weighted average invested capital with respect to the applicable partnership interest at each measurement date.

Measurement date

Invested capital is measured at each of the following times during each partnership tax year: (1) the last day of the partnership tax year; (2) upon occurrence of certain events set forth in the regulations under Subchapter K at which time a partnership may adjust partner capital accounts to reflect a revaluation of partnership property (without regard to whether the partnership would, notwithstanding this provision, use such date to adjust capital accounts); and, (3) any other date provided by the Secretary.

Specified rate

The specified rate, for any partnership tax year, equals the par yield for 5-year High Quality Market (HQM) corporate bonds for the first month of the calendar year with or within which the partnership's tax year begins plus 9 percentage points.

The specified rate keys off of the 5-year HQM Corporate Bond Yield Curve (constructed by Treasury under the Pension Protection Act), which reflects low-risk borrowings, and adds 9 percentage points, to better approximate yields of higher-risk borrowings. The addition of 9 percentage points reflects the recent average difference between an index of CCC and below rated corporate bond yields and the 5-year HQM corporate bond yields.

Applicable percentage

The applicable percentage with respect to any applicable partnership interest is the highest percentage of profits of the partnership that could be allocated with respect to the partner (consistent with the partnership agreement and determined as if all performance targets with

respect to such interest had been met). Authority is provided to the Secretary to prescribe regulations for the calculation of the applicable percentage in cases in which the percentage of profits of a partnership which may be allocated to the applicable partnership interest under the partnership agreement may temporarily exceed the highest percentage determined.⁸

Invested capital

Invested capital means, with respect to any partner as of any day, the excess of: the sum of the total cumulative value determined at the time of contribution, of all money or other property contributed by the partner to the partnership on or before such day (reduced by liabilities the partnership is considered to assume with respect to, or take subject to, the property), plus the aggregate amounts of the partner's distributive share of income and gain (other than unrealized gains resulting from revaluations of partnership property) as of such day **over** the aggregate value, determined at the time of distribution, of all money or other property distributed to the partner from the partnership on or before such day (reduced by any liabilities the partner is considered to assume with respect to, or take subject to, the property), plus the aggregate amount of the partner's distributive share of loss and deductions of the partnership as of such day (determined without regard to unrealized losses resulting from revaluations of partnership property).⁹

Proceeds from an applicable loan to a partner directly or indirectly from the partnership, any other partner, or any person related to a partner or the partnership, shall not be taken into account for the purposes of determining the amount of a partner's invested capital. A related party means any related person within the meaning of section 267(b) or 707(b).

Assuming only one measurement date during the tax year, the simplified formula for a partner's deemed compensation amount is:

$$\text{Deemed Compensation Amount} = \text{Specified Rate} \times ((\text{Applicable Percentage} \times \text{Invested Capital of all partners}) - \text{Invested Capital of partner})$$

Accelerated inclusion of deemed compensation amount

If a taxpayer who holds an applicable partnership interest sells or disposes of such interest during a taxable year in the applicable period, the deemed compensation amount to be included for such tax year is equal to the amount determined as if no such sale or disposition had occurred plus the product of such amount and the number of taxable years beginning after the date of the sale or disposition and

⁸ For example, it is not the intent that in the case of an applicable partnership interest that is allocated 100-percent of profits in a given tax year due to a catch-up provision in the partnership agreement, that the applicable percentage should be 100-percent (assuming such applicable partnership interest is not otherwise entitled to 100-percent of overall partnership profits).

⁹ It is intended that a partner's invested capital equates the partner's book capital account required to be maintained under section 704(b) and the regulations with certain modifications. Unlike a partner's 704(b) book capital account, invested capital is calculated without regard to untaxed gains and losses resulting from the revaluation of partnership property.

before the last day of the applicable period. The applicable period is the 10-year period beginning the later of: (i) the date the taxpayer acquired the applicable partnership interest; or, (ii) the last measurement date (other than a measurement date that was only a measurement date due to it being the last day of a tax year) in which there was an increase in the amount of the taxpayer's applicable percentage of aggregate invested capital.

Long-term capital loss

A taxpayer recognizing a deemed compensation amount is treated as concurrently realizing a long-term capital loss in equal amount. Other sections of the Code providing for the deduction, limitation, and carryforward of capital losses apply. No further restrictions are placed on the partner's capital loss under this provision.

Reporting requirement

A partnership is required to report each partner's deemed compensation amount for the tax year to the partner and the IRS. In the case of a partner that is a partnership or S corporation, a similar reporting requirement applies.

Items reported to a taxpayer by a partnership under this provision shall be included in such taxpayer's taxable income for the tax year of the taxpayer that ends with or includes the last day of the reporting partnership's tax year.

Conforming amendments

Section 1061 is repealed.

Regulatory authority

The Secretary has broad regulatory authority to carry out the provision, including guidance to address prevention of abuse. Guidance will also provide for the application in tiered partnership situations and to address transfers or liquidations of an applicable partnership interest including but not limited to the transfer by gift, transfer at death, substituted basis transactions, and arm's-length nonrecognition transactions.

Effective date

The amendments made by this section apply to tax years of a taxpayer beginning after date of enactment, with or within which ends the taxable year of a partnership which begins after such date.