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Rep. Levin Takes Another Shot at Carried Interests

Rep. Sander Levin (D-MI) introduced a new bill that would change the taxation of carried interest. Although most advisers have little concern that carried interest legislation will be enacted in the near term, this article explains why the bill warrants attention.

Rep. Levin has been a frequent and vocal advocate in Congress for legislation to address the taxation of carried interests. He introduced the initial bill to address carried interest taxation in 2007 and has remained involved in efforts to change the treatment of carried interests in subsequent congressional sessions. For example, he introduced proposals in 2009 and 2012 that built on his initial 2007 bill and advocated passage of legislation that included rules to address carried interest taxation in 2008–2010. A little over three years after he last introduced a bill addressing the taxation of carried interests in 2012 (the “2012 Carried Interest Bill”), Rep. Levin introduced a new carried interest bill—H.R. 2889, “The Carried Interest Fairness Act of 2015” (the “2015 Carried Interest Bill”)—on June 25, 2015. Sen. Tammy Baldwin (D-WI) introduced companion legislation in the Senate (S. 1686) on that same day.

While most advisers have little concern that carried interest legislation will be enacted in the near term, the 2015 Carried Interest Bill warrants attention for a number of reasons. First, this bill continues to follow the general approach of prior carried interest bills introduced by Rep. Levin, despite the introduction in 2014 by former Ways and Means Committee Chairman Dave Camp (R-MI) of proposed legislation taking a different approach to taxing carried interests in the context of comprehensive tax reform. Rep. Levin obviously was not moved to change his approach in light of former Rep. Camp’s bill. Second, the 2015 Carried Interest Bill includes certain modifications to Rep. Levin’s 2012 Carried Interest Bill, which are noteworthy in signaling Rep. Levin’s latest thinking on carried interest taxation.

Finally, there are numerous issues, like “enterprise value,” for which the 2015 Carried Interest Bill reflects no material modifications to address concerns previously raised.

I. General Approach to Tax Carried Interests

Like prior bills proposed by Rep. Levin, the 2015 Carried Interest Bill essentially would provide that all income allocated to a partner providing specified services to an “investment partnership” would be taxed at ordinary income rates, except to the extent the partner could prove, under a narrow set of rules relating to qualified capital, that a portion of the partner’s return was attributable to invested capital. In other words, any income allocated with respect to an “investment services partnership interest” (an “ISPI”) that could not be properly traced to a “qualified capital interest” would be presumed to be attributable to services and, hence, taxable at ordinary income rates.

II. Changes to 2012 Proposal

The changes from Rep. Levin’s 2012 Carried Interest Bill are relatively limited. The primary changes relate to the scope of the legislation—that is, who would be subject to the legislation. In addition, a narrow change has been made to the application of the rules for qualified capital interests in the context of family partnerships.

A. Exempt Domestic C Corporations

Unlike prior carried interest bills introduced by Rep. Levin, the proposed rules for partners providing investment management services to partnerships in the 2015 Carried Interest Bill would not apply to domestic C corporations, except to the extent provided in regulations. That is, while the “investment partnership” limitation incorporated in the 2012 Carried Interest Bill seemingly would have had the effect of exempting most of the large C corporations that participate in business joint ventures, the 2015 Carried Interest Bill simply provides an explicit general exemption for domestic C corporations.

B. Modify Rules Defining an “Investment Partnership”

The 2015 Carried Interest Bill makes certain modifications to the definition of an “investment partnership.” By way of background, the bill provides that an interest in a partnership would not be subject to the proposal unless the partnership were an “investment partnership.” The “investment partnership” limitation is intended to focus the impact of the legislation on service partner interests in investment funds like private equity, hedge, real estate, and venture capital. Under the 2012 Carried Interest Bill, the term “investment partnership” was defined as any partnership if, at the end of any calendar quarter ending after the date of enactment: (1) substantially all of the assets of the partnership are specified assets (determined without regard to any section 197 intangible), and (2) more than half of the capital of the partnership is attributable to qualified capital interests which (in the hands of the owners of such interests) constitute property not held in connection with a trade or business.

The 2015 Carried Interest Bill contains alterations affecting both prongs of the “investment partnership” definition. As an initial matter, rather than satisfying the twopronged requirements at the end of any calendar quarter, it would be necessary to satisfy the requirements at the end of any two consecutive calendar quarters.

More significantly, the second prong would be modified to reduce the level of passive ownership necessary to qualify as an “investment partnership.” As modified, the second prong would apply if “less than 75 percent of the capital of the partnership is attributable to qualified capital interests which constitute property held in connection with the trade or business of the owner of such interest.” This change would cause a partnership to qualify as an “investment partnership” with 25 percent less passive capital investment than was required under the 2012 Carried Interest Bill, which would result in a broader range of partnership interests being taxed as ISPIs and could have implications for the enterprise value issue, discussed below.

Although the 2015 Carried Interest Bill does not provide guidance as to what it means to hold a qualified capital interest in connection with the owner’s trade or business, the bill does provide a rule attributing a trade or business from one person to another and potentially prolonging trade or business treatment beyond the period during which such business is actually conducted. Specifically, a trade or business of any person “closely related” to the owner of such interest would be treated as a trade or business of the owner; whether a person is “closely related” to the owner would be determined by reference to sections 267(b)(1) (family members) or (b)(9) (persons and controlled charitable entities), and section 267(b)(4) (grantor and fiduciary of trust), with certain modifications. In addition, an interest would be treated as held in connection with a trade or business during any tax year if such interest were so held by the person during any three tax years preceding the relevant tax year.

With respect to the requirement that substantially all of the partnership’s assets must constitute “specified assets” (i.e., the same investment assets that a person must manage in order to be subject to the legislation), the 2015 Carried Interest Bill would create a look-through rule such that, for interests in certain entities, the entity interest would not be treated as a specified asset. Instead, it would be possible to look through to the assets of that entity which may be trade or business assets and not specified investment assets (like stock, partnership interests, etc.). Under this rule, a partnership would be treated as owning its proportionate share of the assets of a “specified entity.” For these purposes, a “specified entity” means, with respect to any partnership (which is referred to as the upper-tier partnership), any person that engages in the same trade or business as the upper-tier partnership and is (1) a partnership all of the capital and profits interests of which are held directly or indirectly by the upper-tier partnership, or (2) a foreign corporation that does not engage in a trade or business in the United States and all of the stock of which is held directly or indirectly by the upper-tier partnership.

C. Family Partnerships

The 2015 Carried Interest Bill would provide some relief for partners in certain family partnerships. The relief makes it possible for partners in certain family partnerships to hold “qualified capital interests” that are exempt from the carried interest legislation even though there is no unrelated qualified capital interest holder against which such partner can benchmark his or her allocations, as required by the “allocation rule” related to qualified capital interests.

Very generally, the “allocation rule” provides that items of gain and loss (and any dividends) allocated with respect to a qualified capital interest will not be subject to recharacterization if: (1) allocations are made to the qualified capital interest in the same manner as such allocations are made to other qualified capital interests held by partners who do not provide investment management services to the partnership and who are not related to the partner holding the qualified capital interest; and (2) allocations made to the non-service partners are significant compared to the allocations made to the qualified capital interests of the service partners. Under the modification contained in the 2015 Carried Interest Bill, the holder of any “specified family partnership interest” could meet the allocation rule for qualified capital interests by proving receipt of allocations in the same manner as such allocations are made to partners providing no services, regardless of whether those partners are “related to the partner holding the qualified capital interest.”

For purposes of this provision, a “specified family partnership interest” means any ISPI if (1) such interest is an interest in a qualified family partnership, (2) such interest is held by a natural person or by a trust with respect to which each beneficiary is a grantor or a person related to the grantor as a family member under section 267(b)(1), and (3) all other interests in such qualified family partnership with respect to which significant allocations are made are held by (i) persons who are related to the natural person or trust referred to in (2), or (ii) provide services that cause a partnership interest to be an ISPI.

A qualified family partnership means any partnership if (1) the partnership does not hold itself out to the public as an investment advisor, and (2) all of the capital and profits interests of such partnership are held by (i) specified family members, (ii) any person closely related to a specified family member (applying the same closely related standard as applies for purposes of the investment partnership determination), or (iii) any other person if such interest is an ISPI with respect to such person. Specified family members generally are determined by reference to individuals who are treated as a single shareholder under section 1361(c)(1). In effect, a qualified family partnership must be owned by family members, family trusts, and/or investment service providers.

D. Publicly Traded Partnerships and Section 751

One small change bears mentioning for publicly traded partnerships (“PTPs”) that own ISPIs. Under the 2012 Carried Interest Bill, ISPIs held by a partnership generally would be taken into account under section 751, except in the case of exchanges of PTP interests. The exception for PTP interests applied to all partners in the PTP, regardless of whether any partner was providing services with respect to the lower-tier partnership.

The 2015 Carried Interest Bill qualifies that this result applies “[e]xcept as otherwise provided by the Secretary.”

III. Enterprise Value

As previously mentioned, the 2015 Carried Interest Bill makes no material changes to the 2012 Carried Interest Bill that appear designed to favorably address concerns raised about the treatment of enterprise value. The “frequently asked questions” document issued in connection with the 2015 Carried Interest Bill, however, contains the following comments:

- The basic goal of the carried interest legislation attempts to put fund managers in the same position as other working taxpayers by providing that net capital gain attributable to such managers' carried interest is taxed at ordinary income rates and subject to employment taxes. This has been the main thrust of all prior versions of carried interest legislation, including the version passed by the House, the version considered in the Senate, and, the administration's proposals. In drafting this bill, there has been further consideration of how to treat income recognized by a manager upon the sale of his interest (including his carried interest).
- "Enterprise value" is a term that has been used to describe the increased value of the fund attributable to the fund's good track record or valued brand (i.e. goodwill). In some real world cases, a buyer might rationally pay more than liquidation value for the manager's interest.
- Since the introduction of the carried interest legislation, suggestions have been made to provide broad exemptions for enterprise value. One concern with such an approach would be that fund managers could potentially over-allocate the purchase price to enterprise value to get around the main purpose of the legislation and obtain a better tax result.
- In response to previous concerns relating to enterprise value, provisions were included in the Carried Interest Fairness Act of 2012 that provided that in certain circumstances, amounts recognized on the sale or exchange of a carried interest that are attributable to business intangibles (like goodwill) will retain its character as capital gains, and not be recharacterized as ordinary income – mirroring similar treatment that other businesses have under current law with respect to goodwill. This provision remains in the current draft and also maintains that a taxpayer's failure to comply with the valuation regulations prescribed by the Secretary could result in the imposition of a 40-percent underpayment penalty to address the potential valuation and allocation issues mentioned above.
- These modifications to the Carried Interest Fairness Act over time reflect continuing efforts by the bill sponsors to be sure of the right balance that would appropriately characterize enterprise value without violating the principal fairness goals of the Carried Interest Fairness Act of 2015.

The description of the 2012 Carried Interest Bill's effort to address the enterprise value issue is curious. While legislation considered in 2010 did contain a specific rule reducing the tax rate on gain attributable to certain section 197 intangibles, the 2012 Carried Interest Bill contains no such provision. Instead, the addition of the "investment partnership" limitation in the 2012 Carried Interest Bill was intended to provide some relief with respect to the enterprise value issue, among other issues. Specifically, in many situations, intangibles related to the sponsor's business will be owned by the fund sponsor's management entity. That entity presumably would be owned primarily by persons engaged in the trade or business of the entity, and substantially all of the entity's assets may not be comprised of specified assets. If the management entity is not an "investment partnership," interests in that entity could not be ISPIs. Thus, gain on the sale of an interest in such an entity would be recast as ordinary income under the carried interest legislation only to the extent of gain attributable to ISPIs held by the management entity (i.e., ISPIs are treated as “hot assets” under section 751).

The 2015 Carried Interest Bill does contain certain provisions making it slightly easier to be treated as holding an interest in connection with a trade or business or avoid treatment of certain entity interests as specified assets. Both sets of changes increase the chances that the management entity will avoid treatment as an investment partnership, albeit only in narrowly prescribed circumstances.

Significantly, however, the 2015 Carried Interest Bill increases by 25 percent the “trade or business” ownership that can exist with respect to a partnership that qualifies as an investment partnership. As a result, a lesser amount of passive ownership can cause a partnership to be treated as an “investment partnership.” For investment sponsors that are publicly traded, this change could cause the sponsor entity to be treated as an “investment partnership,” bringing squarely into play the enterprise value issue for the historical owners of these entities. In addition, it is not unusual for some private sponsors to have outside passive ownership in the sponsor entity. Again, the change made from 2012 to 2015 would increase the risk that these entities would be treated as “investment partnerships,” thus invoking the enterprise value issue for owners of these entities as well.

IV. What Did Not Change

Numerous changes suggested with respect to the 2012 Carried Interest Bill were not included in the 2015 Carried Interest Bill. As a result, the exception for qualified capital interests continues to apply in contexts that are far too narrow. Character mismatches can occur through application of the legislation depending on the ordering of income and loss recognition and when ISPIs are distributed. Significant ambiguities continue to exist with respect to the definition of an “investment partnership.” Anti-avoidance rules relating to disqualified interests remain overbroad and ambiguous such that many non-abusive business arrangements could be caught by the rules. Gain recognition would occur when grandfather status terminates for PTPs relying on qualifying income from ISPIs. This list merely scratches the surface of issues that still could be addressed.

Additionally, while former Rep. Camp’s 2014 version of carried interest legislation purported to exclude real estate, the 2015 Carried Interest Bill provides for no such exclusion.

V. Conclusion

Prior commentary discussing the 2012 Carried Interest Bill illustrated significant deficiencies in the bill’s scope of coverage and general approach to taxing holders of ISPIs. The 2015 Carried Interest Bill makes little progress in addressing these deficiencies. While Rep. Levin’s continued loyalty to his historical approach is noteworthy, and the changes made deserve attention, numerous important issues merit further consideration.

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