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Taxation of Carried Interest Under Chairman Camp's Tax Reform Proposal

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On February 25, 2014, House Ways and Means Committee Chairman Dave Camp (R-MI) issued a sweeping tax reform discussion draft, numbering almost 1,000 pages (the Discussion Draft). This alert summarizes proposals included in the Discussion Draft that affect the private investment funds industry, including the taxation of carried interest.

While it has been widely reported that the immediate possibility of Congressional action on this legislation appears low, it is possible that this legislation, or legislation based on this proposal with similar effect, could be considered and enacted in the future.

Tax Brackets and Rates

Under the Discussion Draft, the current tax brackets for individuals would be consolidated into three brackets: 10%, 25% and 35%. The 35% bracket would begin at $400,000 for single filers and $450,000 for joint filers. For high-income taxpayers, the benefit of the 10% tax bracket would phase out. Many deductions for individual expenses would be eliminated or only deductible against lower tax-bracket income.

The preferential tax rate structure for net capital gain would be repealed. Instead, noncorporate taxpayers could claim an "above the line" deduction equal to 40% of adjusted net capital gain, i.e., net capital gain plus qualified dividend income. In effect, for 35% tax-bracket taxpayers, the adjusted net capital gain would be taxed at 60% of 35%, or 21%. It also would be subject to the current "net investment income" tax of 3.8%, for a total tax rate of 24.8%.

The highest marginal corporate tax rate would be reduced from 35% to 25%, phased in from 2015 to 2019.

Carried Interest

Chairman Camp's proposal to tax certain carried interest as ordinary income differs from prior legislative proposals. This proposal can be analogized to a related-party loan, although "loan" terminology or characterization is not actually used in the Discussion Draft.

Very generally, the proposal, in effect, (i) treats a general partner as having received an interest-free "loan" from the limited partners equal to the partnership's capital that will fund the general partner's carried interest, (ii) tracks an interest-like return on this loan and, (iii) *when realized*, recharacterizes capital gain as ordinary income to the extent the general partner has not otherwise realized ordinary income.

Although the technical rules are quite complicated, as a general matter, if the General Partner has a 20% carried interest, it would be treated as having "borrowed" 20% of the fund's capital contributions. The interest-like amount deemed earned on this "loan" would be the amount of capital gain that is subject to recharacterization as ordinary income. The stated intent of the proposal is to approximate the portion of the general partner's earnings that the proposal's drafters view as compensation for managing the fund's capital. It is unclear, however, whether any management fee income earned by the general partner or related management company might reduce the amount of capital gain subject to ordinary income recharacterization.

When is this provision effective?

As mentioned above, although it has been widely reported that the likelihood of this particular tax reform bill being enacted appears low, it is always possible. Further, some or all of its provisions might resurface in other tax bills and be enacted in the future.

The Discussion Draft provides that this provision would be effective for taxable years beginning after December 31, 2014, with no "grandfathering" provisions for existing partnerships.

Who is covered?

The provision applies to the holder of an "applicable partnership interest" (API).

What is an API?

An API is any interest in a partnership which, directly or indirectly, is transferred to or held by the taxpayer in connection with the performance of services by the taxpayer, or any other person, in any "applicable trade or business."

Observation:

- If a general partner holds both a carried interest and a capital interest resulting from a capital commitment to the fund, the capital interest does not prevent the general partner from holding an API, but it is unclear whether the capital interest (as well as the carried interest) would be treated as an API.

What is an applicable trade or business?

An "applicable trade or business" is any trade or business conducted on a regular, continuous, and substantial basis which, regardless of whether the activities are conducted in one or more entities, consists (in whole or in part) 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.

As a result, the provision appears to require that a trade or business determination must be made at two levels: first, either the partnership or the carried interest recipient (it is unclear which) must conduct a trade or business and, second, the investments in which the partnership invests must constitute trades or businesses.

Are all private investment funds (or their carried interest recipients) engaged in trades or businesses?

Many private equity and venture capital firms currently take the position that their investment funds are not engaged in a trade or business, but rather are engaged in investing activities. The Section-by-Section Summary (issued simultaneously with the Discussion Draft) provides that a partnership that satisfies the three criteria above "is in the trade or business of selling businesses" and that the "businesses bought and sold by the partnership are its inventory." As mentioned, it is unclear from the Discussion Draft and the Section-by-Section Summary whether it is the partnership or the carried interest recipient that is engaged in a trade or business.

Observation:

If it is the partnership that is treated as engaged in a trade or business (as is suggested by the Section-by-Section Summary), adverse US tax consequences could result to tax-exempt and non-US investors, if interpreted more broadly to apply for other Internal Revenue Code purposes.

The Joint Committee on Taxation's Technical Explanation of the provision states that:

"developing trades or businesses 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 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."

In a later example regarding a private equity fund in which an API is held, the Technical Explanation assumes that:

"the terms of the fund's investment permit the fund and its service providers to have management input in the portfolio businesses which is designed to develop the value of the portfolio companies over the period of the fund's investment."

Observation:

- It is unclear whether the provision would extend to certain hedge funds whose managers do not have, and do not represent to investors that they have, management input with respect to the companies in which they invest.

Are all private investment fund investments engaged in trades or businesses?

Most portfolio companies held by private investment funds are engaged in trades or businesses. While some start-up companies might not reach the level of operations necessary to constitute a business, the Discussion Draft specifies that any activity involving research or expenditure shall be treated as a trade or business for these purposes. As a result, venture-backed companies are likely to constitute "trades or businesses" even in their earliest stages.

While not explicitly provided for in the Discussion Draft, the Section-by-Section Summary asserts that the provision "would not apply to a partnership engaged in a real property trade or business." Although unclear, this might turn on whether the real property investments made by the partnership (*e.g.*, shopping malls or hotels) constitute trades or businesses. The language does imply that a trade or business exists at the partnership level.

How much gain is recharacterized as ordinary income?

The taxpayer's "Net Capital Gain" (NCG) from an API is recharacterized as ordinary income up to the amount of the taxpayer's "Recharacterization Account Balance" (RAB).

NCG generally includes any long- or short-term capital gain or loss allocated by the partnership or recognized upon disposition of the partnership interest or upon a distribution in-kind from the partnership, in all cases with respect to an API.

- Nonrecognition provisions under the Code would not apply to dispositions of APIs.
- Transfers of APIs to related parties would trigger ordinary income inclusions even if there were no NCG upon such disposition.
- Distributions in kind would not be treated as nontaxable events with respect to APIs.

The RAB, very generally, is the cumulative annual interest-like return (calculated at the long-term applicable federal rate – currently 3.36% - plus 10%) on the capital deemed "loaned" with respect to the general partner's carried interest less any ordinary income realized by the general partner and the prior amounts recharacterized as ordinary income under this provision.

Observations:

- Since NCG includes items recognized on disposition of an API, so-called "enterprise value" is subject to ordinary income recharacterization.
- Transfers of carried interest to certain team members during the life of a fund may trigger ordinary income inclusions.

Capital losses that "reverse out" capital gains previously recharacterized as ordinary income seem to maintain their character as capital losses which would result in significant character mismatches.

- NCG subject to recharacterization does not appear to distinguish between the general partner's carried interest or capital interest.
- Since the RAB accrues annually, those funds that sell their portfolio companies earlier will have a lesser percentage of their capital gain recharacterized as ordinary income. This is quite punitive to fund managers who invest in companies for the long term, and contrary to tax and public policy that has otherwise encouraged long-term investments.

What is the Base Amount upon which the RAB's return is calculated?

Very generally, it is the general partner's carried interest percentage multiplied by the fund's total capital contributions, less the general partner's capital contributions to the fund.

More specifically, the Discussion Draft defines such base as the "Applicable Percentage" multiplied by the "Aggregate Invested Capital" less the "Specified Capital Contribution."

The "Applicable Percentage" is the highest percentage of the partnership's profits that could be allocated with respect to such API for the taxable year, consistent with the partnership agreement, and assuming such facts and circumstances with respect to such taxable year as would result in such highest percentage.

Observation:

- Under a "GP catch-up" provision, a general partner could be allocated up to 100% of profits after a preferred return in order to reach its carried interest percentage of the fund's cumulative net profits. Although the Secretary is permitted to prescribe other rules, it appears the Applicable Percentage could be 100% in funds with "catch-up" allocations.

The "Aggregate Invested Capital" is the average daily amount of invested capital of the partnership for such taxable year, where invested capital is the total cumulative value, determined at the time of contribution, of all money or other property contributed to the partnership on or before such day.

- Loans by a partner to the partnership or equity-related debt of the partnership are treated as invested capital.
- Invested capital is only reduced by distributions in liquidation of interests in the partnership.

The "Specified Capital Contribution" is the average daily amount of contributed capital with respect to an API for the taxable year, where contributed capital is the excess of the total cumulative value, determined at the time of contribution, of all money or other property contributed by the partner to the partnership over the total cumulative value, determined at the time of distribution, of all money or other property distributed by the partnership to the partner.

- Loans to the holder of an API from the partnership or any other partner (or related persons) are not considered Specified Capital Contributions.

Observation:

- The Specified Capital Contribution is reduced for distributions to the holder of the API, but the Aggregate Invested Capital is not reduced until liquidating distributions are made. This will result in the general partner having more of its gains recharacterized as ordinary income since it will not get "credit" for its proportionate capital contributions after it receives distributions from the fund.

What is Net Ordinary Income that reduces RAB?

"Net Ordinary Income" is the net of the taxpayer's allocations of items of income, gain, loss and expense with respect to its APIs (determined without regard to items of gain taken into account into determining NCG).

Observations:

- Since the RAB is reduced by Net Ordinary Income, those funds that have a mix of interest and capital gain as part of their overall return strategy will have a lesser percentage of their capital gain recharacterized as ordinary income than those that only generate capital gains and losses.

The recharacterization formula is "intended to approximate the compensation earned by the service partner for managing the capital of the partnership." It is unclear whether or how a taxpayer's APIs can be aggregated so that it can get "credit" for its management fees that are taxed as ordinary income for managing the capital of the partnership.

Example

Assumptions:

Fund = $100 million. LPs contribute $99 million. GP contributes $1 million. GP receives a 20% carried interest. Specified Rate is 15%.

All capital is drawn down at inception (rather than on a just-in-time basis) for simplicity.

Year 2: GP is allocated and distributed $2 million of interest income at the end of Year 2.

Year 3: GP is allocated $10 million of net capital gain in Year 3.

The GP is allocated $1 million of expenses in each year.

Years 1 and 2 Annual Recharacterization Amounts (ARAs)

= Specified Rate x (Applicable Percentage x Aggregate Invested Capital
- Specified Capital Contribution)

= 15% x (20%* x 100 million - $1 million) = $2.97 million

*Technically, the GP is entitled to 20.8% of cumulative net profits because it also receives a return on its capital like any other investor – so 20% plus 1% of 80% = 20.8%. It is unclear whether the API, and therefore the applicable percentage, only includes the carried interest percentage.

Year 2 Recharacterization Account Balance

= (ARAs from APIs + Carryover RAB) – (Net Ordinary Income from APIs
+ Prior Year's Recharacterized Amount)

= (Year 2 ARA + Carryover of Year 1 RAB) – ((Interest income – Fund expenses)
+ PY Recharacterized Amount)

= ($2.97 million + $2.97 million) – ($2 million - $1 million + $0)

= $4.94 million

Year 3 Recharacterization Account Balance

= (Year 3 ARA + Carryover of Year 2 RAB)
– (NOI + PY Recharacterized Amount)

= ($3.0* million + $4.94 million)
– ($0** +$0)

= $7.94 million

*The $2.97 annual recharacterization amount increases in Year 3 because the Specified Contribution of the GP was reduced from $1 million to $0 as a result of the distribution of interest income to the GP at the end of Year 2.

**The Net Ordinary Income is zero regardless of the fund expenses since Net Ordinary Income can only be a positive number.

Year 3 Recharacterized Amount

$10 million net capital gain:

$7.94 million is recharacterized as ordinary income and $2.16 million remains as net capital gain.

It is unclear whether the management fee *income* received by the GP would be included in New Ordinary Income (and therefore could cause a reduction in RAB).

Are there any "workarounds"?

Under the provision, the Secretary has the authority to issue broad anti-abuse rules, including to prevent abuse through (i) the allocation of income to tax-indifferent parties or (ii) a reduction in the invested capital of the partnership (including attempts to undervalue contributed or loaned property).

Further, the regulations provide (i) that partnership interests would 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 and (ii) for the application of the provision in cases of tiered structures of entities to avoid abuse.

Mandatory Basis Adjustments

Under current law, partnerships with a substantial built-in loss (i.e., the partnership's adjusted basis in its property exceeds the fair market value of that property by more than $250,000) immediately after a transfer of an interest in the partnership are required to adjust the basis of their assets. Similar rules apply in the case of a partnership distribution of property to a partner. For funds with many portfolio companies, including various financing rounds in the same portfolio companies, these adjustments can create significant administrative burdens and require partners to disclose certain pricing information upon transfer. The mandatory basis adjustments are not required if the partnership is eligible to elect, and does so elect, to become an "electing investment partnership" (EIP) which requires, among other things, that the transferee partner is disallowed certain losses. Most private equity and venture capital funds are eligible to elect, and do elect, to be EIPs.

Under the Discussion Draft, mandatory basis adjustments would be required regardless of whether a substantial built-in loss exists and the EIP regime would be repealed. Even more significantly, corresponding adjustments would be required in cases involving tiered partnerships.

Qualified Small Business Stock

The Discussion Draft would repeal the qualified small business stock rules which currently allow 50%, 75% or 100% (depending on date of acquisition) of capital gain from the disposition of qualified small business stock held for at least 5 years to be excluded from income or rolled over into other qualified small business stock.

Certain State and Local Government LPs Subjected to UBTI Taxation

Under current law, organizations that are otherwise exempt from tax under Internal Revenue Code Section 501(a), such as private pension plans, are nonetheless subject to tax under the "unrelated business taxable income" (UBTI) rules. It has been unclear whether certain state and local entities, such as public pension plans, that are exempt under Code Section 115(l) as government-sponsored entities, as well as under Code Section 501(a), are subject to tax as UBTI. Many state and municipal pension plans that invest into private equity and venture capital funds have asserted that they are not subject to tax on UBTI.

Under the Discussion Draft, all Code Section 501(a) organizations would be subject to tax on UBTI regardless of their Code Section 115 status. If this provision were to become law, it is quite likely that it would be challenged on constitutional grounds.

Publicly Traded Partnership Qualifying Income

Under current law, a publicly traded partnership (PTP) is a partnership whose interests are traded on an established securities market or are readily tradable on a secondary market or the substantial equivalent thereof. A PTP is subject to tax in the same manner as a corporation. An exception from corporate tax treatment applies to certain PTPs if at least 90% of the partnership's gross income for the taxable year is "qualifying income." Qualifying income, very generally, includes passive income such as interest, dividends and capital gains. Some hedge funds currently rely on the 90% qualifying income test to be exempt from PTP corporate taxation.

The Discussion Draft would repeal the "qualifying income" exemption other than for partnerships with 90% or more of their income from activities relating to mining and natural resources.

Determination of "Net Earnings from Self-Employment" for Partners and LLC Owners

Under current law, self-employment taxes are based on "net earnings from self-employment" which generally means the gross income derived by an individual from any trade or business carried on by the individual, less allowable deductions. If an individual is a general partner of a partnership, "net earnings from self-employment" generally includes the partner's distributive share of income or loss from any trade or business carried on by the partnership. A limited partner's share of partnership income or loss, however, generally is excluded for these purposes except to the extent attributable to guaranteed payments. Under the proposal, general partners, limited partners and LLC owners would be treated similarly. Very generally, owners who materially participate in the trade or business of the partnership or LLC would treat 70% of their combined compensation and distributive shares as "net earnings from self-employment" and the remaining 30% as earnings on invested capital not subject to self-employment tax. Owners who do not so materially participate would have no amount treated as "net earnings from self-employment."

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