What's News in Tax

I Spy an ISPI—Proposed Carried Interest Legislation May Apply to More Businesses and Transactions Than You Think

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As currently drafted, proposed carried interest legislation could apply to interests in partnerships in virtually any kind of business and could fundamentally change how partnerships are taxed. This article first provides a brief background regarding the proposed legislation. Then it explores the potential breadth of certain definitional and operative rules contained in the most recent iteration of the legislation.

Since 2007, there has been considerable discussion of so-called "carried interest legislation."[1] In large part, this discussion has centered on how managers of investment funds ought to be taxed on their shares of fund income.[2] Nonetheless, the most recent iterations of carried interest legislation considered by Congress would apply far beyond investment funds and would do more than change the character of a partner's distributive share of partnership income. Instead, at least as currently drafted, the proposed legislation could apply to interests in partnerships in

[1] A carried interest generally is an interest in partnerships profits (rather than capital). Nonetheless, referring to the legislation currently under consideration as "carried interest legislation" is misleading. As is explained in this article, the legislation applies to more than profits interests and to more than what are traditionally considered to be carried interests.

[2] The genesis of much of the debate about changing the taxation of carried interests was a 2007 version of an article by Victor Fleisher, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. Rev. 1 (2008). The first version of carried interest legislation (H.R. 2834, 110th Congress (2007)) was described as a bill "to amend the Internal Revenue Code of 1986 to treat income received by partners for performing investment management services as ordinary income received for the performance of services." The "fact sheet" accompanying this bill explained that the bill was intended to change the treatment of carried interests received by managers in the investment management industry. *See also* David Weisbach, *The Taxation of Carried Interests in Private Equity Partnerships*, 2007 TNT 147-32 (July 31, 2007); Lee Sheppard, *Carried Away: Management Fee Conversion*, 116 Tax Notes 532 (August 13, 2007). For a more recent article, see Sam Goldfarb, *Direction of Carried Interest Provision in Extenders Bill Upsets Some Policymakers*, 2010 TNT 119-1 (June 22, 2010), which notes the desire of some policymakers to change the way carried interests held by managers of investment businesses are taxed.

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virtually any kind of business and could fundamentally change partnership tax practice.[3] As is explained in greater detail below, absent regulations to the contrary:

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[3] As is explained below, the potentially expansive breadth of the legislation currently being considered stems from both the broad definition of "investment services partnership interest" and the narrow drafting of the "qualified capital" exception to the rules applicable to such interests. The potential breadth of the legislation is surprising, not only given the focus on investment partnerships referenced in note 2, *supra*, but also given that the drafters appear to have rejected the approach proposed by the Administration in its budget of changing the tax treatment of *all* carried interests, in favor of focusing on only "investment services partnership interests." For information regarding the Administration's budget proposal, see Dept. of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (May 2009). In its description of the revenue provisions contained in the Administration's 2010 budget proposals, the Staff of the Joint Committee on Taxation made the following observations about the Administration's broader carried interest provision:

> Less sophisticated taxpayers engaged in business in partnership form may unknowingly violate the proposal due to its potential complexity and difficulty of application. For example, in the case of a small business in partnership form whose capital structure does not lend itself to comparison of similar capital interests, the proposal may not function effectively to exclude from ordinary income treatment the income from the service provider's capital interest in the partnership; this analysis could be complex. Thus, the proposal could be criticized as a trap for the unwary in the case of unsophisticated taxpayers . .
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> The proposal could be criticized as likely to require many individual taxpayers to analyze their circumstances and possibly file forms or statements that give rise to little or no change in tax liability . . .
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> In a similar vein, it may be argued that very few partners outside the asset management business -- due to the nature of their business assets and activities -- can convert material amounts of labor income to capital gains and dividends, thus lowering the tax rate and avoiding employment and self-employment tax that applies to individuals who earn labor income directly. Most business activities are not so inherently conducive to such conversion and avoidance. Thus, it is argued, it would be preferable to limit the scope of the proposal to businesses involving investment management services, rather than to extend ordinary income and employment tax treatment to service-providing partners in any business. Operating income of most businesses is already ordinary income under present law. Thus, as a practical matter, the proposal's effect is to impose self-employment tax on operating income that is already taxed at ordinary income tax rates, and to treat gain on sale or exchange of the partnership interest as ordinary income rather than capital gain.

Staff of the Joint Comm. on Tax'n, Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal, reprinted at 2009 TNT 172-54 (Sept. 9, 2009).

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- The legislation seemingly could apply to an interest in a partnership in *any* industry (other than "family farming") if the partnership has interests in lower-tier entities and the interest holder (or a related party) provides services with respect to the interests in, or the businesses of, the lower-tier entities.[4] For example, the legislation could apply to an interest in a partnership that engages in a retail, manufacturing, distribution, or other operating business through lower-tier partnerships or corporations. It likewise could apply to interests in "internal partnerships" between related members of corporate groups as well as to joint ventures between unrelated entities.

- The legislation could apply not only to partnership interests held by individuals, but also to interests held by corporations, partnerships, and others.

- Not all holders of partnership interests who have put money or property into the deal would necessarily be immune from the legislation's operative rules. This can be the case in tiered structures, as well as in situations in which certain aspects of the legislation's "qualified capital" rules cannot be met. The legislation does not apply only to "profits" interests.

- The legislation's operative rules can require losses to be suspended, change the character of gain on dispositions of partnership interests, override nonrecognition rules that otherwise might apply to certain transfers of partnership interests, cause distributions of partnership property to trigger income, and subject a partner to self-employment tax on recharacterized amounts. That is, the rules extend beyond changing the character of a partnership interest holder's distributive share of partnership gain. The loss deferral rules and the rules changing the treatment of dispositions of interests may be of particular concern to corporations that hold interests in partnerships—both from a tax perspective and a financial statement perspective.

- The legislation would add substantial complexity to partnership tax law and would fundamentally change how partnership tax issues are analyzed. As is explained below, because of the potential breadth of the legislation, any taxpayer with a partnership in its structure—or that is considering using a

[4] Both the bill that passed the House on May 28, 2010 (H.R. 4213), and the Amendment in the Nature of a Substitute that Sen. Baucus introduced on June 24, 2010, would amend the Code to add a new section 710. Proposed new section 710(c)(3) would contain the exception for family farms. Both the House bill and the amendment introduced in the Senate are described in text *infra*. Except to the extent specified otherwise, all section references are to the Code or to proposed new sections of the Code.

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partnership or engaging in a transaction involving a partnership—would need to assess whether there are any "investment services partnership interests"—or "ISPIs"—present, to what extent "qualified capital" exceptions may be available, and how the operative rules might apply. Making these determinations may be difficult in many situations.

- The operative rules can apply to some structures in which there are not any partnerships present. The legislation contains broadly drafted "disqualified interest" rules that can apply to certain debt, derivatives, and options, as well as to certain equity interests in foreign corporations, when the value of such instruments or interests are derived from the performance of certain kinds of services. Although these rules appear to be "anti-abuse" rules, they are drafted broadly and seemingly could apply in some non-abusive situations. Moreover, a 40-percent penalty can apply to underpayments attributable to disqualified interests unless disclosure and other requirements are met.

As is explained below, although carried interest legislation has passed the House on multiple occasions, it has not yet passed the Senate. Nonetheless, the Senate came close to passing carried interest legislation in the last few weeks and might consider such legislation again this year. Consequently, taxpayers may want to familiarize themselves with the most recent iterations of the legislation and to consider whether and how the legislation might apply to them. For example, taxpayers may want to assess the potential application of the legislation not only to their current structures, but also to transactions they may be contemplating involving forming partnerships, adding "tiers" of entities, transferring partnership interests, or making distributions of property with respect to partnership interests. Moreover, taxpayers need to be aware that, under the disqualified interest rules, the legislation can apply even in some structures in which there are no partnerships present at all.

The most recent iteration of the proposed legislation is long (over 30 pages) and extremely complex. This article does not attempt to walk through all of the technical provisions of the proposed legislation in detail.[5] Instead, it merely

[5] For more detailed background information regarding the current law treatment of carried interests, the evolution of proposals to change the treatment of such interests, and the technical details of such proposals, see Carol Kulish Harvey and James B. Sowell, *Carried Interest Update: Provisions in House Extenders Bill Reflect Modifications to Prior Carried Interest Proposals*, 12 Business Entities, Mar.-Apr. 2010, at 16 (hereafter "*Carried Interest Update*"); Carol Kulish Harvey and James B. Sowell, *Proposals on Carried Interests: The Current State of Play*, 11 Business Entities, July-Aug. 2009, at 4 (hereafter "*Proposals on Carried Interests*"); and Carol Kulish Harvey and Eric Lee, *A*

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attempts to raise awareness of some of the situations in which, absent regulations, the legislation seemingly could apply outside the investment management context –with a particular focus on the legislation's potential application to partnerships that conduct operating businesses through lower-tier entities.[6]

The article first provides some brief background regarding the legislation. Then, it explores the potential breadth of certain of the definitional and operative rules contained in the most recent iteration of such legislation.

Background

In 2007, Rep. Sander Levin (D-MI) introduced a bill (the "2007 Levin Bill") in the House of Representatives to change the treatment of certain carried interests.[7] The 2007 Levin Bill contained a complex set of definitions and operative rules and served as the model for subsequent versions of carried interest proposals. For example:

- In November 2007, Rep. Charles Rangel (D-NY) introduced tax reform legislation (the "Reform Bill"). The Reform Bill included a number of revenue-raising provisions to offset the costs of the reform, including a carried interest provision that adopted the structure and statutory language of the 2007 Levin Bill, with some changes.[8]

- Shortly thereafter, the House Ways and Means Committee used a carried interest proposal substantially identical to the proposal included in the Reform Bill to offset the cost of providing temporary alternative minimum tax ("AMT") relief.[9] This iteration of AMT relief legislation passed the House, but not the Senate.

Technical Walk Through the Carried Interest Provisions Contained in Chairman Rangel's Tax Reform Proposal, 86 Taxes 77 (2008).

[6] The legislation also could raise issues for publicly traded partnerships ("PTPs") and other taxpayers in particular industries. The legislation, for example, includes certain special rules for holders of interests in PTPs. This article does not discuss these special rules and by no means attempts to examine every situation in which the legislation could apply. Instead, the article merely highlights several selected situations as examples of the legislation's potential breadth.

[7] H.R. 2834, 110th Cong. (2007). At the time that Rep. Levin introduced the bill, Rep. Rangel was Chairman of the House Ways and Means Committee. Rep. Levin currently is Acting Chairman of the House Ways and Means Committee.

[8] The Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. (2007). For a detailed discussion of the carried interest provisions in the Reform Bill, see Harvey and Lee, *supra* note 5.

[9] Temporary Tax Relief Act of 2007, H.R. 3996, 110th Cong. § 611 (2007) (a bill to extend certain expiring provisions and to provide AMT relief for 2007).

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- In June 2008, the House again passed temporary AMT relief legislation.[10] This legislation included a carried interest provision modeled after that in the Reform Bill, but with certain technical modifications. The carried interest provision was not included in the Senate version of AMT relief legislation, however, and (again) did not become law.

- On April 2, 2009, Rep. Levin introduced an "updated" version of his bill (the "2009 Levin Bill").[11] The 2009 Levin Bill retained the same basic framework as the 2007 Levin Bill, but included some of the technical modifications reflected in the earlier House versions of AMT relief legislation as well as some additional modifications.[12]

More recently, the House included carried interest provisions as a revenue raiser in its version of legislation to extend certain expiring tax provisions. The House first passed this legislation (H.R. 4213) on December 9, 2009, and subsequently passed a modified version on May 28, 2010.[13] The carried interest provisions in the bill most recently passed by the House (the "House Extenders Bill") are based on the prior iterations of carried interest legislation described above, but include some modifications – such as the addition of a "blended rate" for individuals and an exception for family farms.[14] The carried interest provisions generally would be

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[10] The Alternative Minimum Tax Relief Act of 2008, H.R. 6275, 110th Cong. (2008).

[11] H.R. 1935, 111th Cong. (2009).

[12] For a summary of the 2009 Levin Bill, see Kulish Harvey and Sowell, *Proposals on Carried Interests*, *supra* note 5.

[13] The House passed the Tax Extenders Act of 2009 (H.R. 4213, 111th Cong.) on December 9, 2009. For a discussion of the carried interest provisions in the bill that passed the House in December of 2009, see Kulish Harvey and Sowell, *Carried Interest Update*, *supra* note 5. The Senate amended and passed H.R. 4213 on March 10, 2010, without the carried interest provisions but with an extension of unemployment benefits. The Senate renamed the bill "The American Workers, State and Business Relief Act." As stated in a joint press release, Senate Finance Chairman Baucus and House Ways and Means Chairman Levin subsequently worked with House and Senate leaders to produce a revised version of H.R. 4213, renamed "The American Jobs and Closing Tax Loopholes Act" ("AJCTL Act"). The House passed the AJCTL Act on May 28, 2010.

[14] *See supra* text accompanying note 4 regarding family farms. Note that the drafters of the legislation informally had expressed a reluctance to provide "carve outs" for particular industries. *See, e.g.,* Meg Shreve, *Phased-In Carried Interest Offset to Help Pay For Extenders, Levin Says*, 2010 TNT 91-1 (May 12, 2010). Nonetheless, the exception for family farms suggests a willingness to provide exceptions in at least some situations. Some of the modifications in the Proposed Senate Amendment (such as the addition of a presumption regarding the holding period for section 197 intangibles) similarly respond to concerns raised by particular industries. Thus, it appears that Congress may be willing to

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effective for tax years ending after December 31, 2010 (or, in the case of dispositions and distributions, transactions after such date). The Joint Committee on Taxation ("JCT") has released a technical explanation of the House Extenders Bill (the "JCT Explanation of the House Extenders Bill").[15] The Committee on Ways and Means did not issue a report in conjunction with the House Extenders Bill.

After the House passed its version of the Extenders Bill, the Senate sought to pass its version of extenders legislation. Although House and Senate leaders had worked together on the extenders legislation that had passed the House,[16] Senate leaders made modifications to the legislation—including to the carried interest

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address some concerns raised by taxpayers (to the extent those taxpayers are aware of the potential impact of the legislation in the first place).

[15] Staff of the Joint Comm. on Tax'n, Technical Explanation of the Revenue Provisions Contained in the "American Jobs and Closing Tax Loopholes Act of 2010," for Consideration on the Floor of the House of Representatives, JCX-29-10 (May 28, 2010) (hereafter "JCT Explanation of the House Extenders Bill"). Some courts might not view a technical explanation prepared by JCT staff as constituting "official" legislation history. In the context of a "blue book" prepared by JCT staff after legislation was enacted, the Tax Court has stated that such explanation, although entitled to great respect, does "not technically rise to the level of legislative history because it was authored by a congressional staff and not by Congress." Rivera v. Commissioner, 89 T.C. 343, 349 (1987). The Supreme Court and the Tax Court, however, have relied upon JCT staff explanations in analyzing tax statutes. *See, e.g.*, FPC v. Memphis Light, Gas & Water Div., 411 U.S. 458, 471-72 (1973); Estate of Sachs v. Commissioner, 88 T.C. 769 (1987). Further, a staff explanation may be accorded weight if it was released in advance of congressional consideration of the matter described, as was the case with the JCT Explanation of the House Extenders Bill. See discussion in Robinson v. Commissioner, 119 T.C. 44 (2002), in which the majority opinion relied on a JCT explanation of legislation to overturn the Tax Court's earlier decision in Redlark v. Commissioner, 106 T.C. 31 (1996), rev'd and remanded, 141 F.3d 936 (9th Cir. 1998). In Redlark, the Tax Court had disregarded the same Blue Book language at issue in Robinson given the lack of corroboration in the actual legislative history. As Judge Thornton indicated in his concurring opinion in *Robinson*:

> Other opinions of this Court echo the notion that we require some direct corroboration of congressional intentions before we defer to Blue Book expressions thereof. See *Allen v. Commissioner,* 118 T.C. 1, 15 (2002) (" Although the Staff of the Joint Committee's explanation of a tax statute may be entitled to respect as a document that is prepared in connection with the legislative process by individuals who are intimately involved in that process, we shall not hesitate to disregard the expressions set forth therein where, as here, those expressions are barren of corroboration in the legislative history."); *Zinniel v. Commissioner*, 89 T.C. 357, 367 (1987) (" the portion of the General Explanation [of the Blue Book] * * *, standing alone, without any direct evidence of legislative intent, is not unequivocal evidence of legislative intent"), aff'd. 883 F.2d 1350 (7th Cir. 1989). *Robinson*, 119 T.C. at 94.

[16] See *supra* note 13.

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provisions—in an effort to secure votes. To this end, Sen. Baucus (D-MT), the Chairman of the Senate Finance Committee, introduced several possible "amendments in the nature of a substitute" to the House Extenders Bill. The most recent set of amendments was introduced on June 24, 2010 (the "Proposed Senate Amendment"). The carried interest provisions in the Proposed Senate Amendment followed the same basic framework as the provisions in the House Extenders Bill, but with some modifications. For example, the Proposed Senate Amendment provided exceptions for interests in partnerships when all allocations and distributions are made pro rata based on capital contributions[17] and modified the blended rate provisions for individuals. The Proposed Senate Amendment contained the same effective date for the carried interest provisions (keyed off of December 31, 2010) as in the House Extenders Bill. There is no Senate Finance Committee report, or JCT explanation, for the Proposed Senate Amendment.

A Senate cloture vote on June 24, 2010, fell three votes short of the 60 required to stop debate on the extenders legislation. While there was controversy about some issues associated with the carried interest provisions, other aspects of the legislation also proved controversial. The Senate set aside the extenders and moved to separate consideration of other portions of the bill and to other legislation.[18] Nonetheless, it is likely that the Senate will consider extenders legislation again later this year. Thus, it is possible that the carried interest provisions may resurface in the near future, either as part of another extenders bill or as a revenue offset in other legislation. Further, the fact that both the House Extenders Bill and the Proposed Senate Amendment contained the same effective date suggests that, if carried interest legislation is enacted this year, such legislation may well be effective for tax years ending after December 31, 2010 (or, in the case of distributions and dispositions, transactions after such date).

This article focuses on the scope of the most recent iterations of carried interest legislation, as reflected in the House Extenders Bill and the Proposed Senate Amendment. Note, however, that if Congress continues to consider carried interest legislation, it may make changes to the most recent versions of the legislation as part of the legislative process. Further, even if Congress ultimately enacts carried

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[17] Although it is not clear, this modification may have been intended to ameliorate the impact of the legislation on family partnerships. Nonetheless, as is explained below, even if the House agrees to this modification, the legislation still can be expected to affect many family partnerships.

[18] *See Senate Democrats Abandon Extenders Package As Third Substitute Amendment Falls,* 2010 TNT 122-1 (June 24, 2010). Some of the controversy, for example, stemmed from concerns about the potential impact of the extenders legislation on the deficit.

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interest legislation that follows the approach taken in the House Extenders Bill and the Proposed Senate Amendment, the Treasury Department ("Treasury") might modify the scope and application of the relevant rules in the future; the most recent iterations of the proposed legislation grant Treasury authority to, in effect, rewrite the proposed statutory rules to the extent necessary to achieve the legislation's intended purpose.[19]

The Proposed Legislation

Very generally, the proposed legislation provides that certain bad things can happen to persons (including entities) that hold ISPIs or disqualified interests, subject to exceptions that can apply if certain "qualified capital" requirements are met. The ISPI rules are the heart of the statute. The disqualified interest rules appear to be "anti-abuse" rules aimed at preventing taxpayers from structuring arrangements that circumvent the purposes of the carried interest provisions through the use of other than partnership interests. The discussion below highlights the expansiveness of the definition of an ISPI, the potential limits to the availability of the "qualified capital" exception, and the breadth of the operative rules applicable to ISPIs. Then it touches upon the potentially broad reach of the disqualified interest rules and the penalties associated with those rules.

A. The Broad Scope of the ISPI Definition—Here an ISPI, There an ISPI, Everywhere an ISPI?

The definition of ISPI is not targeted specifically to the investment management industry. Instead, the definition uses generic language and is quite broad in scope. Although the definition may have been drafted with a view to covering typical investment fund arrangements, it appears that interests in partnerships in any industry (other than family farming) potentially could be covered.[20] The definition also is not limited to profits interests.

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[19] See proposed new section 710(f), which allows the Secretary of Treasury to prescribe such regulations or other guidance as is necessary or appropriate to carry out the purposes of proposed section 710, including regulations or other guidance (1) to modify the application of section 710 to the extent consistent with the purposes of such section, (2) to prevent the avoidance of the purposes of section 710, and (3) to coordinate section 710 with other income tax provisions. Except to the extent specified otherwise, references to section 710 or to proposed new section 710 are to section 710 as contained in the Proposed Senate Amendment.

[20] As indicated above, the most recent iterations of the legislation would exempt family farming. This is accomplished by excluding from the definition of "specified asset" certain farms used for farming held by a partnership all of the

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The proposed definition of an ISPI in the latest iteration of the legislation generally is as follows:

> Any interest in a partnership which is held (directly or indirectly) by any person if it was reasonably expected (at the time that such person acquired such interest) that such person (or any person related to such person) would provide (directly or, to the extent provided by the Secretary, indirectly) a substantial quantity of any of the following services with respect to assets held (directly or indirectly) by the partnership:
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> (A) Advising as to the advisability of investing in, purchasing, or selling any specified asset.
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> (B) Managing, acquiring, or disposing of any specified asset.
>
> (C) Arranging financing with respect to acquiring specified assets.
>
> (D) Any activity in support of any service described [above].[21]

For purposes of the definition of an ISPI, the proposed legislation generally would define "specified assets" as securities, real estate held for rental or investment, *interests in partnerships*, commodities, or options or derivative contracts with respect to such securities, real estate, partnership interests, or commodities.[22] For this purpose, securities include stock in corporations.[23]

The JCT Explanation of the House Extenders Bill expands upon what kinds of assets constitute "specified assets" and what it means for services to be provided with respect to assets held directly or indirectly by a partnership. In this regard, the

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interests of which are held by members of the same family. See proposed new section 710(c)(3).

[21] See proposed new section 710(c)(1). The JCT Explanation of the House Extenders Bill explains that activities in support of the listed services are intended to include supervising others who perform the services as well as assisting others who perform the services. *See* JCT Explanation of the House Extenders Bill, *supra* note 15, at 268. Proposed new section 710(c)(4) provides that a person is treated as related to another person for purposes of the definition of IPSI if the relationship between such persons is described in section 267 or 707(b).

[22] See proposed new section 710(c)(2). (Emphasis added.)

[23] Securities are defined by reference to section 475(c)(2), without regard to the last sentence thereof (relating to section 1256(a) contracts). This definition includes stock; ownership interests in publicly traded partnerships; notes, bonds, debentures, and other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; certain options, forward contracts and short positions; and certain other positions.

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JCT Explanation of the House Extenders Bill makes the following significant points:

- With regard to the definition of "specified assets," the term "security" includes (among other things) a share of corporate stock as well as an interest in a publicly traded or widely held partnership; a "partnership interest" includes any partnership interest that is not otherwise treated as a security for purposes of the provision (such as an interest in a partnership that is not widely held or publicly traded).

- For example, if a private equity fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held, the partnership interest is a specified asset.[24] Further, it "*is intended that income from providing the services described . . . with respect to the business or assets of a partnership in which the partner (directly or indirectly) holds a partnership interest is subject to the recharacterization rule of the provision*."[25]

- With regard to the requirement that services be performed with respect to assets held directly or indirectly by the partnership, "assets held (directly or indirectly) by the partnership are considered to include assets held through any other entity, including a corporation."[26]

Several observations are worth making about the scope of the proposed statutory definition of ISPI (absent administrative guidance to the contrary).

First, because the definition can apply to a partnership interest held (directly or indirectly) by a "person," an interest held (directly or indirectly) by an individual, trust, estate, partnership, company, or corporation can be an ISPI. ISPI treatment is not limited to interests held by individuals.[27]

Second, an interest can be an ISPI if, at the time the person acquired the interest, it was "reasonably expected" that such person—or a related party—would provide a

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[24] JCT Explanation of the House Extenders Bill, *supra* note 15, at 268.

[25] *Id.* at 268, n.673. (Italics added.) Query whether the same analysis applies for a person who provides services with respect to the management of the business of a corporation, the stock of which is held by a partnership. Given that both stock in a corporation and an interest in a partnership are treated as specified assets, if managing the business of a partnership is treated as managing the partnership interest (i.e., the specified asset), it may be hard to argue that managing the business of a corporation is not managing the corporate stock.

[26] *Id.* at 269.

[27] See section 7701(a)(1) for the statutory definition of a "person."

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substantial quantity of certain kinds of services.[28] Thus, an interest can be an ISPI if it was reasonably expected that the interest holder (or a related party) would provide services at the time the interest was issued—even if the holder no longer performs any services at the time the legislation is enacted (or, in fact, never performed any of the anticipated services).

Third, because corporate stock and partnership interests are specified assets, *any interest in a partnership that holds interests in lower-tier partnerships and corporations seemingly could be an ISPI*. Based on the JCT Explanation of the House Extenders Bill, all it appears to take for such an interest to become an ISPI is for the holder of such interest (or a related party) to perform a substantial quantity of certain kinds of services with respect to the interests of the lower-tier entities *or the businesses of such entities*. This broad treatment appears to be a perhaps inevitable consequence of the decision to draft the definition of ISPI generically, rather than statutorily limiting ISPI treatment to certain industries. That is, the drafters needed to treat a person who provides services with respect to the business of lower-tier entities as an ISPI holder in order to encompass typical private equity structures. Unfortunately, however, the broad language also pulls in a host of partnerships that engage in operating businesses through lower-tier entities.

Fourth, a wide range of services can implicate the ISPI rules—particularly when services provided to lower-tier entities are taken into account. Further, even though a service provider must provide a "substantial" quantity of certain kinds of services in order to trigger ISPI treatment, the legislation does not define "substantial." For example, it is not clear whether the determination as to whether the services performed are "substantial" is made based upon the absolute amount of time the interest holder spends performing such services or based on the portion of the defined services provided by the holder as opposed to by other persons, the portion of the service provider's time spent on defined services relative to other services, or some other relative measure.

Consider the following examples:

> *Example 1 – Manufacturing Joint Venture*. Corporation A manufactures widgets in certain states. Corporation B, which is not related to

[28] Note that, notwithstanding the general definition of ISPI, proposed new section 710(d)(3)(A) would allow an interest that is not an ISPI to become an ISPI if the interest holder starts to provide services at some time after the acquisition of the interest. Proposed new section 710(d)(3)(B) provides rules for determining the holder's "qualified capital" in such a case.

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Corporation A, manufactures widgets in other states. Corporation A and Corporation B decide to enter into a widget joint venture classified as a partnership. The partnership will conduct its business through lower-tier partnerships and corporations. Corporation A and Corporation B will be involved in managing the businesses of the lower-tier entities. Because the interests in the lower-tier entities are specified assets and Corporation A and Corporation B provide management services with respect to the businesses of the lower-tier entities, the interests held by Corporation A and Corporation B could be ISPIs (particularly in light of the language in the JCT Explanation of the House Extenders Bill). As is explained below, this could affect the ability of Corporation A and Corporation B to use losses from the venture as well as the tax consequences of future transactions involving their interests in the venture. Further, if Corporation A and Corporation B contributed property to the venture, they will have to carefully scrutinize the relevant rules (described below) to see if they can benefit from exceptions to ISPI treatment.[29]

Example 2 – Secretarial Staff in Operating Business. Same as above, except that the joint venture also issues partnership interests to certain historic employees of Corporation A and Corporation B as an incentive for those employees to stay on as corporate employees. The joint venture issues a small interest to Marge, who has served as a secretary to the CEO of Corporation A for many years. The CEO plays an active role in the management of the joint venture's business. Marge might be viewed as engaging in activities in support of managing specified assets, such that Marge's interest might be viewed as an ISPI (to the extent her services are viewed as "substantial").

Example 3 – Retired Founder. In 1970, Jack founded a partnership that engages in a retail business through lower-tier operating entities. Jack

[29] As is explained further below, because both partners in Example 1 provide services, it may be difficult for Corporation A and Corporation B to get comfortable that they can rely on the "qualified capital" exceptions, even though both contributed capital, prior to the issuance of administrative guidance. This is because the qualified capital exceptions include an "allocation requirement" that compares allocations to an ISPI holder to allocations to non-service-provider partners. In addition, if the partners are entitled to allocations that are not completely proportionate to contributed capital (e.g., because (1) the parties will continue to receive allocations that disproportionately relate to their contributed businesses; (2) one partner bears greater risk with respect to the performance of the combined business; or (3) one partner performs a greater role in the continuing management of the overall enterprise), the exception for qualified capital will not likely benefit these partners.

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performed substantial services for the businesses of the operating entities through 2000, at which point he retired. Jack, however, continues to hold an interest in the partnership. Because Jack was expected to perform substantial services managing the operating businesses at the time he acquired his interest, Jack's interest would appear to be an ISPI—even though he no longer performs any services.

Example 4 – Internal Partnership in Corporate Group. Corporation X and Corporation Y are members of an affiliated group. Corporation P is the common parent of the affiliated group and all employees of the group are employed by this entity. Corporation X and Corporation Y form an "internal partnership," with each contributing to the partnership the stock of a subsidiary entity. Corporation P, Corporation X, Corporation Y, and the subsidiary entities are engaged in a telecommunications business. Corporation P (which is related to Corporation X and Corporation Y) has authority to make decisions, through its officers and employees, regarding the disposition of the subsidiary entities and plays a role in managing and financing the businesses of those entities. The interests of Corporation X and Corporation Y in the partnership could be ISPIs.[30]

Example 5 – Services Provided by Reasonably Compensated Employees. Sally owns interests in a partnership and a corporation to which Sally is related under section 267. The partnership conducts a fishing business through lower-tier partnerships. The corporation's employees provide managerial services with respect to the partnership's business pursuant to a management contract. The corporation pays its employees an amount of compensation for their services that is reasonable given the facts and circumstances and withholds an appropriate amount of employment tax. Sally performs no services herself. Because a party related to Sally (i.e., the corporation) performs management services with respect to specified assets (i.e., the businesses in the lower-tier partnerships), Sally's interest in the partnership seemingly could be an ISPI.

These examples underscore the importance of looking for ISPIs wherever there is a partnership interest. As indicated, ISPIs can exist in any industry. Further, in

[30] As indicated in note 29 *supra* and discussed further in text *infra*, Corporation X and Corporation Y may have difficulty getting comfortable that they satisfy the qualified capital exception in the absence of regulations to the extent there are no non-service provider partners. Further concerns arise to the extent that allocations between the entities are not pro rata.

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tiered structures, there may be ISPIs present at multiple levels.[31] Thus, if enacted, the legislation would make searching for, and identifying ISPIs, critical to analyzing the tax consequences of partnership structures.

B. <u>The Qualified Capital Exceptions – Narrower Than You May Think?</u>

Both the House Extenders Bill and the Proposed Senate Amendment contain exceptions to the operative rules for the portion of an ISPI that is a "qualified capital interest." In addition, the Proposed Senate Amendment includes an exception to the definition of an ISPI for certain pro rata allocations and distributions.

1. Exceptions for Qualified Capital Interests

The exceptions to the operative rules in the House Extenders Bill and the Proposed Amendment apply only to the extent (1) an interest meets the definition of a "qualified interest" *and* (2) the ISPI holder meets an allocation requirement. As is explained below, the exceptions will not apply to every situation in which a service provider has contributed capital to a partnership. Instead, the exceptions are narrower than many may think.

Very generally, a qualified capital interest is so much of a partner's interest in the capital of the partnership as is attributable to: (1) the fair market value of any money or other property contributed to the partnership in exchange for such interest (determined without regard to section 752(a));[32] (2) any amounts that have

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[31] See Kulish Harvey and Sowell, *Carried Interest Update*, *supra* note 5, at ns. 16, 22, and 24, for a discussion of the significance of identifying all the ISPIs in a structure.

[32] The JCT Explanation of the House Extenders Bill explains that the parenthetical added regarding section 752(a) means that, for purposes of determining a partner's qualified capital interest, the fair market value of money or other property contributed by the partner to the partnership for the partnership interest is determined without regard to the deemed contribution rules of section 752(a), and without regard to any other deemed contribution. JCT Explanation of the House Extenders Bill, *supra* note 15, at 274. *See* Kulish Harvey and Sowell, *Carried Interest Update*, *supra* note 5, at n. 22, for a discussion of the significance of the language regarding section 752 in certain employee co-invest structures. Note also the proposed language does not provide for the amount of an ISPI holder's qualified capital interest to be adjusted for "reverse section 704(c)" gain or loss that arises as a result of revaluations of partnership property (*e.g.*, on the issuance of interests to a new partner). This issue was addressed by the JCT in the context of a prior version of the legislation at a time when the return permitted on qualified capital was required to be "reasonable" and could not be higher than the return of any other partner who was not providing services. In its report relating to the Alternative Minimum Tax Act of 2008, the JCT stated:

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been included in gross income under section 83 with respect to the transfer of such interest; and (3) the excess of certain income and gain items over certain loss and deduction items.[33] The qualified capital interest is reduced by distributions from the partnership with respect to such interest and by certain "excess" losses.[34] Significantly, however, an exception to qualified capital interest treatment can apply in the case of interests acquired with the proceeds of loans made or guaranteed by other partners or the partnership.[35] Under the Proposed Senate Amendment (but not the House Extenders Bill), this exception would not apply to the extent the loan were repaid before the date of enactment (unless such repayment were made with the proceeds of a loan from the partnership or another partner).[36]

> It is intended that Treasury Department guidance provide that an allocation of income on invested capital does not fail to be treated as reasonable solely because of appreciation or depreciation in the value of partnership capital prior to the admission of new partners (provided service providers do not thereby convert their compensation to income on invested capital). For example, assume two partners, one of whom is a service provider, each contribute $1 million to a partnership they form, and the partnership assets appreciate to $6 million, at which time a third partner is admitted for a capital investment of $3 million. Earnings at the end of the following year are $900,000, divided equally among the three partners. An allocation of earnings on invested capital to the service-providing partner of $300,000 should not fail to be treated as reasonable solely because it reflects appreciation in the value of the partnership assets as of the time of admission of the third partner. Such an allocation may fail to be treated as reasonable based on other factors identified in Treasury guidance. In particular, it is not intended that the partner that provides services be permitted to treat any amount as income on invested capital to the extent it otherwise would be treated as compensation under the provision.

Staff of the Joint Comm. on Tax'n, *Description of H.R. 6275 – The "Alternative Minimum Tax Act of 2008"*, *reprinted at* 2008 TNT 118-11 (June 18, 2008). Under the prior version, this issue was relevant in connection with virtually all contributions, given that the service partner was entitled to a return only by reference to the lowest return being received by a non-service partner. Given that service partners now can "benchmark" under that allocation rule to any significant non-service partner, contributions by new partners do not present as great an opportunity to destroy the "benchmark" being used by reference to a historic partner. The issue is still relevant, however, to the extent that a service partner makes a new contribution to the partnership, such that the service partner must determine its "benchmark" at that time.

[33] Proposed new section 710(d)(7)(A).

[34] See proposed new section 710(d)(7)(B).

[35] Proposed new section 710(d)(8).

[36] Last sentence of proposed new section 710(d)(8) as contained in the Proposed Senate Amendment.

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As was indicated above, in order for an exception to the operative rules applicable to ISPIs to apply, a partner who holds a qualified capital interest must satisfy an allocation rule. Very generally, the allocation rule requires that: (1) allocations to the qualified capital interest be made *in the same manner* as such allocations are made to other qualified capital interests held by partners who do not provide investment management services (and who are not related to the service provider partner), and (2) allocations made to such other interests be *significant* compared to allocations made to such qualified capital interest. The legislation provides special rules for applying the allocation rule in the case of tiered partnerships.[37] In addition, it specifically grants Treasury authority to provide guidance regarding certain aspects of the allocation rule, including guidance as to how the rule applies when there are no non-service-providing partners.[38]

The JCT Explanation of the House Extenders Bill provides a detailed explanation of the qualified capital rules. For example, it discusses what it means for allocations to be made "in the same manner" as allocations to non-service providers, notes the need for adjustments to qualified capital interests in the case of allocations made under section 704(c),[39] and expands upon the specific

[37] In the case of tiered partnerships, proposed new section 710(d)(4) generally provides that, except as provided in regulations, items allocated to qualified capital interests in a lower-tier partnership in a manner satisfying the allocation rules will retain such character to the extent allocated on the basis of qualified capital interests in an upper-tier partnership.

[38] The JCT Explanation of the House Extenders Bill indicates that, where there are no non-service-provider partners, it is anticipated that Treasury guidance may provide that the pro rata allocation of partnership items to qualified capital interests is consistent with the purposes of the allocation rules and may provide that a portion of such items is not recharacterized as ordinary income. JCT Explanation of the House Extenders Bill, *supra* note 15, at 272.

[39] Section 704(c) generally provides that income, gain, loss, and deduction with respect to property contributed to the partnership by a partner is to be shared among the partners so as to take into account the variation between the basis and fair market value of the property at the time of contribution. That is, built-in gain or built-in loss at the time of the contribution generally is to be allocated to the contributing partner. The JCT Explanation of the House Extenders Bill provides that, to "prevent double-counting of amounts as qualified capital interests when allocations are made with respect to contributed property under section 704(c), proper adjustments are required to be made to the amount of the qualified capital interest to take into account" built-in gain or loss at the time of the contribution. It proceeds to state that, for example, "if the fair market value of the property is greater than the adjusted basis of the property immediately before the contribution, it is intended that adjustments reducing the qualified capital account are to be made in a manner similar to the adjustments made under 704(c) when appreciated property is contributed (a 'forward' 704(c) transaction)." JCT Explanation of the House Extenders Bill, *supra* note 15, at 274-275.

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administrative authority granted with respect to the allocation requirement.[40] Further, in the case of a purchase of an ISPI by another service provider partner, the JCT Explanation of the House Extenders Bill indicates that the purchaser generally succeeds to the transferor's qualified capital account; the purchaser's qualified capital account is *not* measured by reference to the amount paid for the interest.[41]

Determining whether any of the qualified capital exceptions may apply in a particular situation may be no easy feat. As a threshold matter, the taxpayer might need to work with its tax adviser on calculating the amount of its qualified capital interest. This may involve examining how the taxpayer acquired its interest; the source of any debt-financing for the acquisition; the history of partnership distributions, income, and losses since the acquisition; and other information for all years in which the taxpayer has held its interest (including years that have long since passed). Moreover, in situations in which the taxpayer acquired its interest from another service provider in the past, the taxpayer may need to determine what the seller's qualified capital interest was at the time of the sale.[42]

Further, the holder (or its advisor) will need to examine the allocation provisions in the partnership agreement to determine whether the allocation requirements are satisfied. Many partnership agreements contain at least some allocations that are not "straight up." In these situations, interest holders may have trouble getting comfortable that they meet the allocation requirement, notwithstanding that they contributed cash or property to the partnership. Similarly, pending administrative guidance, partnerships without any non-service-providing partners will confront the issue of how to establish that they have qualified capital given the lack of a non-service provider "benchmark." Moreover, a person (including a non-service provider) who contributed capital to an upper-tier partnership may be surprised to realize that he, she, or it can be affected by the carried interest legislation if the upper-tier partnership holds an ISPI (directly or indirectly) in another entity.

It also is important to recognize that, at least as currently drafted, the allocation requirement appears to have a cliff effect. That is, if the requirement is not satisfied, the entire return appears to be "tainted"—not just the part of the return

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[40] JCT Explanation of the House Extenders Bill, *supra* note 15, at 270-276.

[41] *See* JCT Explanation of the House Extenders Bill, *supra* note 15, at 274.

[42] Given the inapplicability of these rules in prior years, the seller would have had no reason to have retained records to facilitate this calculation.

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that can be "benchmarked" against a non-service provider's return on capital. Thus, failing the allocation rule can have severe consequences.[43]

Consider the following examples:

> *Example 6 – Capital Partner Has First Losses, So Economic Deal Fails Allocation Rule*. An entrepreneur contributes cash and partnership interests in several businesses he has started to a new partnership. The entrepreneur agrees to perform services for the businesses, while unrelated investors contribute capital. The entrepreneur agreed to bear losses first, with the investors bearing losses only after the entrepreneur's capital was fully depleted. If the entrepreneur's interest in the new partnership is an ISPI, he may not be able to avail himself of the qualified capital exceptions at all (even though he contributed capital) because allocations are not made to him in the same manner as to the investors.[44]
>
> *Example 7 – Non-Service Provider in Upper-Tier Partnership*. Bob holds an interest in Upper-Tier Partnership (which is engaged in operations through multiple tiers of lower-tier entities). Bob is not a service provider and his interest is not an ISPI. Upper-Tier Partnership, however, holds an interest in Lower-Tier Partnership that is an ISPI. Under the partnership agreement for Lower-Tier Partnership, Upper-Tier Partnership has agreed to subordinate its return on its capital contribution relative to that of certain investors, but will receive a higher proportionate return on its capital if the venture succeeds (to compensate it for the additional risk with respect to its return). Because allocations are not made in the same manner to Upper-Tier Partnership as to other investors in Lower-Tier

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[43] It is interesting to note that, in 1998, when Treasury and the IRS proposed regulations under section 1402(a)(13), which some viewed as presenting the opportunity to impose the self-employment tax on income attributable to partner capital and not services, Congress imposed a moratorium on the issuance of such regulations. Specifically, Congress imposed a moratorium providing that no temporary or final regulations with respect to the definition of a limited partner under section 1402(a)(13) could be issued or made effective before July 1, 1998. Taxpayer Relief Act of 1997, §935. *See generally* E. Field, *The Stealth Moratorium on the 'Stealth Tax' on Limited Partners*, 81 Tax Notes 808 (Nov. 16, 1998); D. Alexander, *Pass-Through Entities Employment Taxes*, 1 Bus. Entities 20 (1999).

[44] If the service/capital partner does not receive a higher allocation of income to compensate for bearing a higher share of losses, it is possible that Treasury would allow income allocations under this arrangement to satisfy the allocation rule under the authority provided in proposed new section 710(d)(2)(C) relating to allocations that represent a lower return than received by non-service providers.

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Partnership, the allocation rule does not appear to be satisfied. Thus, if Lower-Tier Partnership incurs losses in 2011, Upper-Tier Partnership's share of such losses could be deferred under the operative rules described below. In such case, Bob seemingly would not share in those losses—even though Bob himself does not hold an IPSI and performs no services whatsoever.[45] Similarly, income allocations to Bob would be taxed at a blended rate and would be subject, in part, to the self-employment tax.

Example 8 – Acquisition of Interest Funded by Borrowing That Is Repaid. Jane holds an ISPI in an upper-tier partnership that conducts a hospitality business through lower tier partnerships and corporations. Jane manages the businesses of one of the subsidiary entities. Jane contributed capital to the upper-tier partnership in 1999. Jane borrowed some of the funds needed to make her capital contribution from a party related to the upper-tier partnership under a "balloon" loan. Assume that the carried interest legislation is enacted in November of 2010, with an effective date keyed off of December 31, 2010. At the time the carried interest legislation becomes law, Jane has not repaid the loan. Jane, however, pays back the loan (using her own funds) on December 5, 2010. Under the most recent iterations of the carried interest legislation, Jane seemingly cannot count the amount of the funds that were borrowed to acquire her interest as a qualified capital interest. Although the Proposed Senate Amendment would allow Jane to get qualified capital interest "credit" to the extent the loan were repaid prior to date of enactment, it does not provide any credit for loans repaid after the date of enactment.[46] Moreover, the House Extenders Bill provides no exception to its rule barring credit for interests acquired using certain borrowed funds, even if the borrowed funds are repaid in advance of enactment. Thus, under the House Extenders Bill, Jane would not get any credit for the borrowed portion of her contribution, even if she had repaid the loan in 2002 (before carried interest legislation was even on the horizon).

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[45] As indicated in Example 14 in text *infra*, it is unclear how the "blended rate" rules for individuals would apply in cases in which income or losses "flow up" through multiple levels of ISPIs but ultimately are shared by partners who include individuals.

[46] Although it is not entirely clear, presumably Jane would be able to get credit, under the Proposed Senate Amendment, for any portion of the loan she had repaid prior to the date of enactment, even if she had not fully repaid the loan by such date.

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Example 9 – Borrowing from Affiliate That Is Related to Partnership. A Multinational Corporation (Corporation M) decides to partner with a local business in Brazil (Corporation B). Corporation M will invest through its wholly-owned Brazilian subsidiary (Corporation SB). Corporation SB will borrow money from its parent, Corporation M, and will contribute this cash to the venture in exchange for a 55-percent interest in the capital and profits of the partnership. Corporation B will contribute its existing business assets in exchange for a 45-percent interest in the capital and profits of the venture. Because Corporation M owns, indirectly through Corporation SB, a greater than 50-percent interest in the capital or profits of the partnership, Corporation M would be treated as "related" to the partnership under section 707(b)(1)(A). As a result, because Corporation SB borrowed from a person "related" to the partnership in order to fund its capital, it appears that Corporation SB will have no qualified capital interest in the partnership.[47]

2. *Pro Rata Rule in Proposed Senate Amendment*

The Proposed Senate Amendment includes an additional exception to ISPI treatment that is based on the qualified capital rules; this exception is not in the House Extenders Bill. This exception is drafted as an exception to the definition of an ISPI, rather than as an exception to the operative rules applicable to ISPIs. Under this exception, an interest generally would not be treated as an ISPI if all distributions and all allocations of the partnership (and any lower-tier partnerships) were made "pro rata on the basis of the capital contributions of each partner which constitute qualified capital interests."[48]

Although it is not clear, this exception may have been added in an effort to ameliorate the impact of the legislation on some family partnerships.[49]

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[47] Proposed new section 710(d)(8)(A) provides that a partner will not get credit for qualified capital where the proceeds are funded by a loan from "any *other* partner or the partnership (or any person related to any such *other* partner or the partnership)." (Emphasis added.) The "other" language was added to the proposed statute in the 2009 Levin Bill, apparently in an effort to give people qualified capital credit where they effectively borrow from themselves. The permissible treatment for borrowing from an affiliate, however, would appear to be technically overridden where the partner owns more than 50 percent of the capital or profits of the partnership such that 100-percent owned affiliates of the partner (through attribution) would also be treated as related to the partnership.

[48] Proposed new section 710(c)(4).

[49] Several recent articles have addressed the potential impact of the legislation on family partnerships. *See, e.g.*, Peter Cohn, *Taxes: "Extenders" Provision Might Snare Family-Run Partnerships*, Congress Daily, June 22, 2010; and

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Nonetheless, as is indicated in the examples below, many family partnerships will not be able to meet the requirement that all distributions and allocations, at all tiers, be pro rata on the basis of capital contributions of each partner. Therefore, even if the exception ultimately is included in carried interest legislation, many family partnerships might remain subject to the legislation's operative rules.

> *Example 10 – Family Partnership with Lower-Tier Investments*. Four members of the Smith family own a family partnership and are involved in managing the partnership's business. Each family member contributed 25 percent of the capital to the partnership and shares in 25 percent of the partnership's allocations and distributions. The partnership has invested in lower-tier partnerships, one of which is a real estate development partnership. The developer partner in the real estate development partnership has agreed to bear such partnership's losses first, with the investor partners (such as the family partnership) absorbing losses only after the developer's losses are depleted. The exception from the definition of ISPI that is in the Proposed Senate Amendment may not apply to the interests the Smith family members own in their family partnership given that distributions and all allocations of the lower-tier partnership are not made on a pro rata basis.
>
> *Example 11 – Family Partnership Allocation/Contribution to Capital Issues.* The Jones family manages its investments through a family limited partnership. The patriarch and matriarch of the family formed the partnership and made all the initial capital contributions (directly and through an S corporation). The matriarch and patriarch subsequently transferred some of their interests to their children (who provide no services). Even if the partnership makes all distributions and allocations in accordance with each family member's share of partnership capital, it is not clear that the exception to ISPI treatment contained in the Proposed Senate Amendment can be met given that the children have not contributed capital. Further, pending administrative guidance, there is no unrelated non-service provider partner whose allocation can be used as a benchmark to determine if allocations to family members satisfy the

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Editorial, *The Family Business Revenue Act: A Tax on the Wealthy Becomes a Tax on Mom and Pop*, Wall St. J., June 24, 2010, at A20. See also Stephen Breitstone, *Carried Interest Bill – Impact on Real Estate Partnerships*, 2010 TNT 45-5 (May 9, 2010) ("family-owned, family-operated real estate partnerships with no outside investors would be caught in this web and denied capital gains treatment").

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allocation requirement of the "general" qualified capital interest exception

C. The Operative Rules for ISPIs – Application to Losses, Nonrecognition Transactions, and Beyond

Like the other aspects of the proposed legislation discussed above, the operative rules applicable to ISPIs are complex.[50] Grossly oversimplified, the operative rules provide that the following things happen with respect to ISPIs to the extent the qualified capital rules do not apply:

- All or a portion of the net income with respect to an ISPI is treated as ordinary income (or is subject to the blended rate for individuals), regardless of the character of the income at the partnership level.[51]

- All or a portion of the gain recognized on the disposition of an ISPI is treated as ordinary income (or is subject to the blended rate for individuals).[52] Moreover, *except in the case of certain transfers of ISPIs to partnerships, gain is recognized notwithstanding nonrecognition provisions of the Cod*e.[53] Thus, for example, a transfer of an ISPI to a corporation could produce gain, even if the transaction might otherwise qualify for nonrecognition treatment under section 351 or section 368.

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50 This complexity is compounded by the fact that the qualified capital rules and the special "blended rate" rules that apply to individual holders of ISPIs are layered on top of the operative rules. See proposed new section 710(g) for the special rules applicable to individuals.

51 Proposed new section 710(a)(1)(A). The blended rate rules have the effect of recharacterizing only a portion of the income in the case of individuals. See proposed new section 710(g).

52 Proposed new section 710(b)(1). Proposed new section 710(b)(4) provides rules for dispositions of portions of interests. Proposed new section 710(g)(2) includes rules for applying the blended rate for individuals to dispositions of interests. The Proposed Senate Amendment also includes a proposed new section 710(g)(7)(C), which would provide special rules for the blended rate for dispositions of ISPIs that have been held at least five years (where the partnership's underlying assets also have been held for at least five years). This language includes a presumption regarding the holding period for section 197 intangibles.

53 Proposed new section 710(b)(1) generally would provide that any gain on the disposition of an ISPI would be treated as ordinary income and would be recognized notwithstanding any other provision in the income tax subtitle of the Code. Proposed new section 710(b)(3), however, would provide an exception to the rule that gain is recognized notwithstanding other Code provisions in the case of a contribution of an ISPI to a partnership in exchange for an interest in such partnership, provided that the taxpayer makes an irrevocable election to treat the interest received in the exchange as an ISPI and agrees to comply with reporting and recordkeeping requirements prescribed by the IRS.

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- Ordinary income (or blended rate treatment for individuals) is triggered on the distribution of property to a holder of an ISPI.[54] Moreover, it is not at all clear how (or whether) the qualified capital exception applies in the case of a distribution.[55]

- Although losses allocated to an ISPI holder would be treated as ordinary to the extent of the aggregate net income with respect to such interest during the years the carried interest legislation is in effect, losses in excess of such income would be deferred until either the partnership allocated future income to the partner or the ISPI were sold or redeemed.[56]

- The self-employment tax rules of section 1402 (and the relevant provisions of the Social Security Act) would be amended to provide that any amounts treated as ordinary under the ISPI rules would be taken into account in determining net earnings from self-employment.[57] Thus, the service

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[54] Proposed new section 710(b)(5) generally provides that, in the case of a distribution of property with respect to an ISPI held by a partner, (1) the excess of the fair market value of the property at the time of the distribution over the basis of such property is taken into account as an increase in such partner's distributive share of taxable income of the partnership (except to the extent otherwise taken into account in determining the partnership's taxable income); (2) the fair market value of the property is treated as money distributed; and (3) the basis of the property in the partner's hand is its fair market value. Section 734(b), however, is to be applied without regard to the above rules. Special rules can apply in the case of distributions in connection with transactions described in section 708(b)(1)(B) or section 708(b)(2).

[55] Although proposed new section 710(d)(6) would provide rules for applying the qualified capital exception to transactions described in proposed new section 710(b) (which relates to both dispositions of ISPIs and distributions with respect to ISPIs), the rules in proposed new section 710(d)(6) is titled "Special Rule for Dispositions" and appears to be aimed exclusively at dispositions of ISPIs; it is not clear how the rules apply in the case of distributions of property with respect to ISPIs. It also is not clear that the qualified capital rule is intended to apply to permit nonrecognition treatment in the context of a distribution. In this regard, it should be noted that, in proposed new sections 710(g)(7)(B) and (C)(i)(I) (dealing with the blended rate for property held at least five years), reference is made to "gain or loss from the disposition (or a distribution under subsection (b)(5)) of any asset . . ." Similarly, the rule in proposed new section 710(g)(2) applying the blended rate to transactions described in proposed new section 710(b) is titled "Dispositions, Etc." Both references would seem to indicate a recognition on the part of the tax writers that there is a distinction between "dispositions" and "distributions."

[56] Paragraphs (b)(1)(B) and (b)(2) of proposed new section 710. See proposed new section 710(g) for the application of the blended rate rules to losses in the case of individuals.

[57] *See* section 412(d) of the Proposed Senate Amendment. It appears that the self-employment tax will not apply by reason of this provision to a passive partner (i.e., a partner not engaged in a trade or business of providing services described in proposed new section 710(c)(1)) who is allocated income from a lower-tier ISPI interest. The JCT Explanation of the House Extenders Bill

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provider's share of partnership income could be subject to self-employment tax regardless of the partner's status as a limited partner and regardless of the character of income earned by the partnership (e.g., dividends, interest, capital gain, etc.).

The fact that the operative rules extend beyond recharacterizing a partner's distributive share of partnership income as ordinary may come as a surprise to some taxpayers. Although the general rules applicable to dispositions of partnership interests have been the subject of some discussion in recent weeks,[58] there appears to have been less public discussion of the rules applicable to losses, distributions, and nonrecognition transactions.[59] Nonetheless, the loss disallowance rules may be of immediate concern to owners of businesses that expect to generate net losses—rather than net income—following enactment of the provision (which might be quite common given current economic conditions). Further, corporate holders of ISPIs may be concerned about the loss disallowance rules, as well as the rules providing for ordinary income recognition on distributions and dispositions (which can affect the cost of "unwinding" ventures). Indeed, changing the tax consequences of transactions involving partnership interests may have adverse financial statement implications for some corporations.[60] More generally, the fact that the legislation would override

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makes the following statement with respect to partners in a publicly traded partnership (although presumably the result is not limited to partners in a publicly traded partnership, given that the statute provides no special rule for such partners in this context):

> Income or loss that is treated as ordinary by reason of an investment services partnership interest held directly or indirectly by a publicly traded partnership is not subject to self-employment tax in the hands of an individual holder of such publicly traded partnership interest who is not engaged in the trade or business of performing investment management services described in section 710(c)(1) with respect to assets held directly or indirectly by the publicly traded partnership.

JCT Explanation of the House Extenders Bill, *supra* note 15, at 284.

[58] *See, e.g.*, Diana Furchtgott-Roth, *Skewing the Playing Field for Investment Partnerships,* 2010 TNT 113-7 (June 14, 2010); Peter Lattman and Jenny Strasburg, *Partnership-Sale Tax Provision Draws Fire*, Wall St. J., May 27, 2010.

[59] In terms of the loss disallowance rules, see James M. Peaslee, *Carried Interests and Loss Limits for C Corporations,* 2010 TNT 118-15 (June 21, 2010), and Letter to the Editor, *Carrying Carried Interest Too Far,* Wall St. J., June 28, 2010.

[60] For example, a corporation that had expected to be able to fully utilize a capital loss carryforward with a future capital gain on the disposition of a partnership interest would need to revisit whether recognizing the full amount of the associated deferred tax asset on its balance sheet continues to be appropriate.

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longstanding nonrecognition rules—including rules outside of Subchapter K—may be a significant trap for the unwary. Consider the following examples:

> *Example 12 – Loss Disallowance for Joint Venture Suffering in Soft Economy*. Assume that the carried interest legislation is enacted later this year with a general effective date of tax years ending after December 31, 2010. Corporation X holds an ISPI in Joint Venture, a partnership that engages in a manufacturing business through lower-tier entities. Assume that Corporation X is not able to use the qualified capital exception because the allocation provisions of Joint Venture's partnership agreement that reflect Corporation X's economic deal with its joint venture partners do not comply with the allocation rules. Further assume that Joint Venture has no net income for its tax year ending December 31, 2011. Any losses of Joint Venture that are allocated to Corporation X for such year would be treated as ordinary, but would be suspended.[61]

> *Example 13 – Inability to Offset ISPI Income and Losses in Tiered Structures*. Assume that Corporation Y is a partner in Joint Venture. Corporation Y's interest in Joint Venture is not an ISPI because Corporation Y provides no services with respect to the Joint Venture and no person related to Corporation Y provides such services; however, Joint Venture holds ISPIs in two partnerships—LTP 1 and LTP 2. Assume that, in the first year for which carried interest legislation is effective, LTP 1 generates net income, while LTP 2 generates a net loss. Assume that the qualified capital exception does not apply. It appears that Joint Venture's share of LTP 1's net income would be treated as ordinary income, while Joint Venture's share of LTP 2's net losses would be suspended. There is no rule for netting income from one ISPI against losses from another ISPI.

> *Example 14 – Impact of Tiers on Application of Blended Rate.* Same as Example 12, but assume that Bob, an individual, also is a partner in Joint Venture. Bob does not hold an ISPI. Do the blended rate rules somehow apply to the income and loss that ultimately flows through to Bob? Or, do

[61] The result in this example seems contrary to congressional efforts to stimulate the economy through allowing taxpayers to use losses (e.g., through expanding net operating loss carryback periods).

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the blended rate rules not apply because the holder of the ISPI is a partnership (Joint Venture), rather than an individual?[62]

Example 15 – Override of Longstanding Nonrecognition Rules Outside of Subchapter K. Corporation Z holds a partnership interest that is an ISPI. Assume that the allocations to Corporation Z in the partnership's operating agreement do not satisfy the allocation rule because Corporation Z's return is subordinated to that of certain investors. Corporation Z contributes its partnership interest to a newly formed corporation in exchange for all of the corporation's stock. Because the carried interest rules would override corporate nonrecognition provisions, this transaction apparently could not qualify for nonrecognition treatment under section 351. Similarly, if Corporation Z merges into another corporation in a reorganization qualifying under section 368(a)(1)(A), all assets transferred in the merger could qualify for nonrecognition treatment except for the ISPI interest held by Corporation Z.

Example 16 – Taxable Distribution to Capital Contributor. Service Partner and Investor contribute the same amount of cash to a partnership that holds rental real estate and agree to divide all income and loss equally. Service Partner holds an ISPI because Service Partner provides substantial services in managing the real estate; however, Service Partner is adequately compensated for its services through a management fee. Service Partner's entire ISPI might be a qualified capital interest that satisfies the allocation rule. Nonetheless, if the partnership distributes appreciated property to Service Partner, it appears that gain with respect to the property could be triggered (and could be allocated to Service Partner, subject potentially to section 704(c)). Although it is not clear how the qualified capital exception for dispositions and distributions

[62] These issues are even more difficult in determining how losses tier up through multiple ISPIs in a blended rate context. Under proposed new section 710(g)(5)(A), losses are deferred for individuals only to the extent attributable to the "applicable percentage" of the net loss allocated to such individual. Under proposed new section 710(a)(2)(C), the adjusted basis of an ISPI will not be reduced to the extent that a loss is deferred. So presumably, a partnership holding an ISPI must know what losses are deferred in order to determine its basis in the lower-tier ISPI. Would it be the case that information with respect to losses is provided all the way up the chain to the individual (or ultimate partner) level to determine what portion of the net losses may actually be reported, with information relating to the ultimate usage then being provided back down the chain of ISPIs so that holders of these lower-tier ISPIs could determine their bases in the ISPIs?

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applies in the case of a distribution,[63] it is possible that some portion of the gain might qualify for the exception. Additional gain also could be triggered to the extent the fair market value of the property exceeds the Service Partner's basis in its interest.

D. Find It If You Can—Disqualified Interest Rules, Complete with New Penalties, Can Apply Even When No Partnerships Are Present

Certain of the rules applicable to ISPIs can apply if (1) a person performs (directly or indirectly) certain kinds of services for an entity in which the person holds a "disqualified interest," and (2) the value of such interest (or payments thereunder) is substantially related to the amount of income or gain (realized or not) from the assets with respect to which such services are performed. In addition, a 40-percent penalty can apply if the disqualified interest rules apply and the taxpayer did not properly report amounts with respect to such an interest, unless (1) the taxpayer adequately disclosed the relevant facts, (2) there is substantial authority for such treatment, and (3) the taxpayer reasonably believed such treatment was more likely than not proper.[64]

Given the stakes associated with disqualified interest treatment, it would be helpful if the parameters of disqualified interest treatment were clear. This is not the case. Instead, the definition of a disqualified interest is broad and vague. Further, although the disqualified interest rules appear to be aimed at abusive arrangements, the definition of disqualified interest does not require any abusive

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[63] Proposed new section 710(d)(6) provides that proposed new section 710(b) (which contains rules relating to both dispositions of ISPIs and distributions with respect to ISPIs) will not apply to so much of any gain or loss as bears the same proportion to the entire amount of such gain or loss as (A) the distributive share of gain or loss that would have been allocated to the qualified capital interest if the partnership had sold all of its assets at fair market value immediately before the disposition, bears to (B) the distributive share of gain or loss that would have been so allocated to the ISPI of which such qualified capital interest is a part. Note that this rule applies by reference to a ratio determined based upon the sale or exchange of all of the partnership's assets. Such an approach is rational in the context of a disposition of an ISPI with a qualified capital interest component and is consistent with the title of the provision ("Special Rule for Dispositions"). Such a rule is very hard to apply in a rational manner where select assets are being distributed and gain is being recognized both at the partnership level and with respect to the partnership interest.

[64] See section 412(c) of Proposed Senate Amendment.

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intent. Instead, the proposed legislation defines the term "disqualified interest" as meaning, with respect to any entity:

- Any interest in such entity other than debt,
- Convertible or contingent debt of such entity,
- Any option or right to acquire property (described above), and
- Any derivative instrument entered into (directly or indirectly) with such entity or any investor in such entity.

The term "disqualified interest," however, does not include a partnership interest, an interest in a taxable corporation (except as provided in administrative guidance), and stock in an S corporation (except as provided in administrative guidance). For this purpose, a "taxable corporation" generally is (1) a domestic C corporation or (2) a foreign corporation substantially all of the income of which is either effectively connected with a U.S. trade or business or subject to a comprehensive foreign income tax. Thus, equity interests in some, but not all, foreign entities can be disqualified interests.

The JCT Explanation of the House Extenders Bill includes the following example of the disqualified interest rules:

> [I]f a hedge fund manager holds stock of a Cayman Islands corporation that in turn is a partner in a hedge fund partnership, the manager performs investment management services for the hedge fund, and the value of the stock (or dividends) is substantially related to the growth and income in hedge fund assets for which the manger provides investment manager services, then gain in the value of the stock, and dividends, are treated as ordinary income for the performance of services. The fact that the services are performed for the hedge fund, rather than directly for the Cayman Islands corporation in which the manager has a disqualified interest, does not change the result under the provision. Thus, the gain is not eligible for the capital gain tax rate but rather, both the gain and the dividend are subject to tax as ordinary income. The income is treated as net earnings from self-employment for purposes of the self-employment tax of the individual who performs the services. [65]

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[65] JCT Explanation of the House Extenders Bill, *supra* note 15, at 281.

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Although this example sheds some light as to the intended application of the disqualified interest rules, the statutory language seemingly could apply quite broadly. Indeed, because the disqualified interest rules can apply when no partnerships are even present (but would be part of the partnership provisions of the Code), some potentially affected taxpayers may not even be aware of the rules. For example, a corporation that is structuring an option may not even be aware of the potential application of the partnership tax rules to the treatment of such option. Further, it is not at all clear how to apply the operative rules and exceptions (such as the determination of a qualified capital interest or application of the allocation requirement) in the disqualified interest context, making application of the operative rules quite difficult—assuming the taxpayer identifies the interest as a disqualified interest in the first instance. Moreover, because a taxpayer who is not aware of the disqualified interest rules may not disclose the relevant facts, the 40-percent penalty may prove to be a costly trap for the unwary.

Conclusion

Both the House Extenders Bill and the Proposed Senate Amendment include carried interest provisions that reflect the same basic approach. Contrary to what may be the public perception, this approach covers more than just investment partnerships. Instead, the approach casts a wide net and can affect partnerships in virtually any industry (particularly when partnerships hold interests in lower-tier entities). Further, the approach not only can recharacterize income, but also can suspend losses, override nonrecognition rules, and increase the tax cost associated with dispositions of, and distributions with respect to, certain partnership interests. Moreover, the disqualified interest rules can apply to arrangements that do not even involve partnership interests—potentially subjecting unwary taxpayers to significant penalties.

Although no one knows what the legislative process holds in store, taxpayers may want to familiarize themselves with the broad scope of the legislation if there are any partnerships in their structures, if they are considering forming new partnerships or adding tiers to structures, or if there are any arrangements (including debt and options) the values of which could be viewed as derived from the performance of certain kinds of services. Further, taxpayers may want to carefully monitor developments with regard to carried interest proposals as Congress considers tax legislation—including extenders legislation—later this year. If the legislation moves forward with the currently proposed effective date

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(keyed off of December 31, 2010), there may be only a narrow window of time before it becomes effective.[66]

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[66] Note also that the provision in the Proposed Senate Amendment relating to the impact of the repayment of certain borrowed funds on qualified capital is based on the date the legislation is enacted—not the date the legislation becomes effective. *See* Example 8 in text *supra*.

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