SULLIVAN & CROMWELL LLP

s&c memo

August 11, 2021

Senator Wyden Introduces Carried Interest Bill

Senate Finance Committee Chairman Ron Wyden Proposes a Bill that Would Subject Holders of Carried Interest to Ordinary Income Treatment on an Annual Basis Based on the "Foregone Interest" on a Deemed Loan

SUMMARY

On August 5, 2021, Senate Finance Committee Chairman Ron Wyden introduced the "Ending the Carried Interest Loophole Act" (the "Wyden Bill"), which proposes to change the taxation of carried interest by analogizing carried interest to an interest-free loan. Under the Wyden Bill, holders of carried interest would be required to include a "deemed compensation amount," representing deemed interest on a hypothetical loan, as ordinary income on an annual basis. The "deemed compensation amount" would equal the yield on certain high-quality corporate bonds for the applicable year (which, for June 2021, is equal to 1.21%) plus 9% (total of 10.21%), multiplied by an amount equal to (x) the holder's highest share of profits of the partnership multiplied by the invested capital of all partners *minus* (y) the holder's invested capital in the partnership. The holder would concurrently recognize a long-term capital loss equal to the deemed compensation amount.

DISCUSSION

A. BACKGROUND

Managers of various types of investment funds that are structured as partnerships often receive in exchange for their services a profits interest in the fund that is commonly referred to as "carried interest." Under general principles of partnership taxation, the character of the partnership's income generally flows through to the partner's share of carried interest income. As a result, when the partnership recognizes long-term capital gain, the partner is taxed at preferential tax rates applicable to long-term capital gains,

rather than the tax rates applicable to ordinary income. The partner also generally recognizes income only when the partnership disposes of its investments, realizes income from them, or when the partner sells its partnership interest.

There have been multiple proposals in recent years to change the taxation of carried interest. For example, the Tax Cuts and Jobs Act of 2017 enacted Section 1061 of the Internal Revenue Code (the "Code"), which limits the ability of holders of carried interest to recognize long-term capital gain by extending the holding period that is generally required for long-term capital gain treatment to three years for certain partnership interests.[1] Other proposals have included taxing all amounts allocated to fund managers as ordinary income, except to the extent such income could be recharacterized as income from the manager's contribution of "qualified capital."[2] Most recently, President Biden's "Green Book" proposed that all partnership income in respect to a carried interest that is allocated to individuals with income over $400,000 be characterized as ordinary income.[3] Similar to Senator Wyden's proposal from 2019,[4] the Wyden Bill differs from other proposals in that it changes not only the character of the income associated with carried interest, but also the timing of such income. In addition, because the Wyden Bill taxes a carried interest recipient annually at ordinary rates and provides a corresponding capital loss that cannot be used to offset the ordinary income, a taxpayer may ultimately be taxed on income that the taxpayer did not earn and be left with a capital loss of limited or no use.

B. BILL PROPOSAL

1. Applicability

The Wyden Bill would apply to taxpayers who hold an "applicable partnership interest,"[5] which is defined to be largely consistent with the use of the same phrase in Section 1061.[6] An "applicable partnership interest" includes any partnership interest that is directly or indirectly transferred to or held by a taxpayer in connection with performance of services in an "applicable trade or business," or held by a taxpayer who has received an "applicable loan."[7] An "applicable loan" is a loan issued directly or indirectly by the partnership, another partner, or a person related to the partnership or the other partner, unless the loans are fully recourse to the borrower and with an interest rate equal to the "specified rate."[8] For example, if a fund manager makes a loan, even fully recourse, to allow a partner in the manager to invest in one of its funds, the partner's investment will almost certainly be considered an "applicable partnership interest" and thus subject to these rules because it is very unlikely the interest rate on the loan will equal or exceed the "specified rate." An "applicable partnership interest" also includes any applicable financial instrument or contract (except for some exceptions regarding non-convertible debt) in which the value is determined by reference to the distribution, value, or the operations of an applicable partnership, [9] as well as to the extent provided for in regulations, any interest in an entity other than a partnership if such interest would be treated as an applicable partnership if such entity were a partnership.[10] As drafted, it is unclear whether the definition would pick up performance-based bonuses paid pursuant to an employment contract.

"Applicable trade or business" means activity conducted on a regular, continuous, and substantial basis, that consists of raising or returning capital, and either investing, identifying, or developing "specified assets."[11] "Specified assets" are defined as securities, commodities, real estate held for rental or investment, cash or cash equivalents, or options, derivative contracts, and partnership interest regarding the aforementioned assets.[12] These definitions are generally consistent with the terms as used in current Section 1061.

2. Deemed Compensation Amount

The Wyden Bill utilizes a deemed loan construct. Under this construct, the compensatory element of carried interest is the foregone interest on the deemed loan. That is, if the parties had replicated carried interest with an *actual* loan, the carried interest holder would have had to pay interest on the loan. Arguably, the amount of interest the carried interest holder did not have to pay represents a compensatory element of carried interest, which should be characterized as ordinary income. Determining the amount of the foregone interest requires determining the appropriate principal amount of the deemed loan and the deemed interest rate.

Therefore, the crux of the Wyden Bill is determining the "deemed compensation amount," which is the ordinary income amount that is added to the taxpayer's income annually. The deemed compensation amount is calculated by multiplying a deemed interest rate by (x) the partner's allocable portion of the weighted average of the total invested capital of all partners *minus* (y) the weighted average of capital actually invested by the partner, in each case as of certain measurement dates.[13] Invested capital is measured (1) on the last day of the partnership tax year, (2) upon certain events under the applicable partnership tax rules at which time a partnership may adjust partner capital accounts to reflect a revaluation of partnership property, and (3) other dates provided by the Secretary.[14]

In other words, the Wyden Bill treats the carried interest partner as having borrowed an amount equal to (x) the capital that supports the partner's highest possible share of profits[15] under the applicable partnership agreement, assuming that all performance targets in the applicable partnership agreement have been met, minus (y) any capital actually invested by the partner. This deemed principal amount is then multiplied by a deemed interest rate to arrive at the amount of deemed interest on the hypothetical loan.[16] The interest rate is generally equal to the yield on certain high-quality corporate bonds for the first month of the applicable calendar year, plus 9 percentage points.[17] The partner recognizing the deemed compensation amount would also realize a long-term capital loss in an equal amount, theoretically preventing double taxation of the same income.[18] However, as described below, this approach creates significant risk of taxing unearned income. The formula as reflected in the Detailed Summary accompanying the Wyden Bill is as follows:[19]

Deemed Compensation Amount =

Specified Rate × ((Applicable Percentage × Invested Capital of all partners) – Invested Capital of partner)

For example, assume a situation where the total weighted average invested capital for a fund is $200 million and the general partner invests $4 million of that capital, such that the general partner's share of profits attributable to its invested capital is 2%. Assume that the general partner is also entitled to a 20% interest in profits after the limited partners have received a preferred return. Under the Wyden Bill, the general partner's deemed compensation amount for the current year would be $4.08 million (10.21% specified rate x ((22% applicable percentage x $200 million Invested Capital of all partners) – $4 million Invested Capital of general partner)).

The Wyden Bill would result in taxpayers being taxed without having the cash to pay the tax, and may result in taxpayers being taxed on income they never earned, because its deemed loan construct makes assumptions which will not reflect the economics of any particular carried interest. First, according to the Detailed Summary accompanying the Wyden Bill,[20] the deemed interest rate is based on the average difference between the yields on low-risk borrowings and on CCC-rated (or lower) borrowings. It is not clear why this rate is appropriate, and the summary does not suggest any support for such a rate.[21]

Second, if the partnership's performance does not result in the carried interest recipient receiving allocations of capital gains at least equal to the long-term capital losses deemed to have been correspondingly recognized by the partner, the partner will have recognized ordinary income equal to the deemed compensation amounts over the life of the partnership, and will not have a usable capital loss unless the partner has other capital gains to offset.

For example, if a taxpayer is issued a carried interest in a fund that invests in debt securities, the taxpayer will be required to include in income the deemed compensation amount annually based on the specified rate. If the fund targets debt securities with a lower yield than the "specified rate," the deemed loan construct is completely non-economic—the construct assumes that a taxpayer would borrow money at, for example, a 10% rate in order to invest in a partnership that is investing in debt securities that will yield insufficient income to ever repay the loan. Even if a debt fund yielded more than the specified rate, a taxpayer would still be double taxed: once on the deemed compensation amount, and once when the income is actually earned. Because the debt fund's income will be all ordinary, the corresponding capital loss that the taxpayer is deemed to have recognized will be useless.

Third, since the deemed compensation amount is determined using the highest percentage of profits as if all performance targets are met, there may be a substantial overstatement of income if a "stepped" carry structure is used. In a stepped carry structure, gains are allocated according to a cascading structure made up of sequential tiers. When a tier's allocation requirements are fully satisfied, only the excess funds

would be subject to the allocation requirements of the next tier. For example, a carried interest holder maybe allocated 0% of income until a 10% hurdle rate is met, 10% of the income until a 15% hurdle, and 20% of the income above the 15% hurdle. In such a structure, using the highest percentage of profits would not reflect the economics for two reasons. First, the hurdles may not be met—if the fund's overall return does not exceed 10%, then the carried interest holder would not be allocated any income. Second, even if all performance targets are met, the highest rate still exceeds the actual income allocated to the carried interest holder, because income must be allocated in the lower tiers before the highest rate kicks in. In the example, the Wyden Bill would assume that the deemed loan principal is equal to an amount to allow the carried interest partner to enjoy 20% of the profits of the fund, even though the carried interest partner's overall share of the fund's profits will always be less than 20%.

The deemed loan construct used in the Wyden Bill also fails to reflect the economics of carried interest in that it recharacterizes the tax treatment of the deemed foregone interest as income without also accounting for other deemed transactions that would be expected to result from the deemed loan (e.g., a corresponding compensation deduction, and possibly interest expense deductions and interest income).

3. Disposition of Carried Interests

If a partner sells or disposes of his or her applicable partnership interest within the 10-year period following the acquisition of the interest, the Wyden Bill would accelerate the future deemed compensation amount by requiring the partner to include in income the sum of all deemed compensation amounts that would have been included through the end of the 10-year period. The applicable 10-year period begins on the later of (i) the date the taxpayer acquired the applicable partnership interest or (ii) the last measurement date (other than a measurement date that was only a measurement date due to it being the last day of a tax year) on which there was an increase in the amount of the taxpayer's applicable percentage of aggregate invested capital.[22] In other words, a partner that disposes of a carried interest must include 10 years' worth of deemed interest income, even though a partner that had actually borrowed to invest in the carried interest and subsequently sold the interest within a 10-year period would not have additional interest expense, as the partner presumably could repay the loan with proceeds from the sale. As a result, the sale of an applicable interest may create ordinary income in excess of the sale proceeds.

4. Other Provisions Applicable to Carried Interest

Under the Wyden Bill, if a partner receives a partnership interest in connection with the performance of services, the partner would be treated as receiving property with a fair market value equal to the "liquidation value" of the partnership interest under Section 83, and the partner will be treated as making a Section 83(b) election.[23] This is consistent with the safe harbor provision under proposed regulations §1.83-3(l).[24] The Wyden Bill also proposes to repeal Section 1061.[25] The Wyden Bill would be effective for tax years beginning after the date of enactment with or within which ends a taxable year of a partnership which begins after such date, including for existing partnership interests.[26]

C. NEXT STEPS

The Wyden Bill is likely to be considered during the budget reconciliation bill. The reconciliation process would override the Senate filibuster rules, and can pass the Senate with just 51 votes or 50 votes plus the Vice President as the tie-breaker. Senate Majority Leader Chuck Schumer has announced that he would "immediately move to the FY2022 Budget Resolution with reconciliation instructions" as soon as the infrastructure bill that is currently being considered is completed.[27]

*   *   *

Copyright © Sullivan & Cromwell LLP 2021

ENDNOTES

[1] I.R.C. §1061(a). For analysis of Section 1061 and the proposed regulations, see our prior memorandum by clicking here.

[2] Carried Interest Fairness Act of 2019 (S.781, 116th Cong.), Carried Interest Fairness Act of 2021 (S.1598, 117th Cong.).

[3] General Explanation of the Administration's Fiscal Year 2022 Revenue Proposals, pages 82-83.

[4] Ending the Carried Interest Loophole Act (S.1639, 116th Cong.).

[5] Wyden Bill §1299(b).

[6] I.R.C. §1061(c).

[7] Wyden Bill §1299(b)(1).

[8] Wyden Bill §1299(b)(4).

[9] Wyden Bill §1299(b)(2).

[10] Wyden Bill §1299(b)(2)(A).

[11] Wyden Bill §1299(b)(3)(A).

[12] Wyden Bill §1299(b)(3)(B).

[13] Wyden Bill §1299(c).

Invested capital is (x) the sum of money and property contributed by the partner plus the partner's distributive share of income and gain *minus* (y) the sum of money and property distributed to the partner plus the partner's disruptive share of loss and deductions. Wyden Bill §1299(c)(4).

[14] Wyden Bill §1299(c)(1)(B).

[15] Authority is provided to create regulations for the calculation of the applicable percentage in cases in which the percentage of profits allocated to the applicable partnership temporarily exceed the highest percentage. Wyden Bill §1299(c)(3)(B).

The Detailed Summary accompanying the Wyden Bill states that it is not the intent that "catch-up" allocations are taken into account when determining the "highest share." Ending the Carried Interest Loophole Act – Detailed Summary, at 6, fn.8 [hereinafter *Detailed Summary*].

[16] Wyden Bill §1299(c)(1)(A)(i).

[17] The specified rate will be the par yield for 5-year High Quality Market (HQM) corporate bonds (as defined in Section 430(h)) for the first month of the calendar plus 9 percentage points. The most recent available rate, from June 2021, is 1.21%, meaning the applicable specified rate measured from June would be 10.21%. Wyden Bill §1299(c)(2).

[18] This deemed capital loss is necessary to avoid double taxation in part because although the partner is treated as borrowing under a deemed loan in order to invest in the partnership, the partner is apparently not similarly treated as increasing its basis in its partnership interest. Wyden Bill §1299(a)(2).

[19] *Detailed Summary*, at 6.

[20] *Detailed Summary*, at 5.

[21] Codes and Regulations contain a number of "deemed loan" or "deemed interest rate" provisions, and the interest rates are usually tied to the AFR. However, we are not aware of any Code section that uses an increase of 9% or higher than the AFR. *See* I.R.C. §163 (AFR + 6%), §446 (AFR), §467 (110% of AFR), §1482 (Between 110% and 130% of AFR), §6654 (AFR + 3%), §7872 (AFR).

[22] Wyden Bill §1299(c)(5).

ENDNOTES (CONTINUED)

[23] Wyden Bill §83(c).

[24] REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005).

[25] Wyden Bill Section 2(b).

[26] Wyden Bill Section 2(c).

[27] Letter from Chuck Schumer to Senate Democratic Caucus, August 9, 2021.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.