

# **HANDLING PARTNERSHIP AND LLC COMPENSATORY INTERESTS**

**71<sup>ST</sup> NYU INSTITUTE ON FEDERAL TAXATION**

**LINDA Z. SWARTZ  
CADWALADER, LLP  
OCTOBER 24, 2012**

# TOPICS

---

**CURRENT LAW: THE ROAD TO THE REVENUE PROCEDURES**

**PROPOSED COMPENSATORY INTEREST REGULATIONS**

**CURRENT LEGISLATIVE CARRIED INTEREST PROPOSALS**

## **CURRENT LAW: THE ROAD TO THE REVENUE PROCEDURES**

# **ALTERNATIVE METHODS OF ISSUING COMPENSATORY INTERESTS**

---

**Menu of choices – capital and profits interests,  
vested and unvested.**

- **Some favor employees, some favor partnership.**
- **Balance deferral of income or deductions.**
- **Timing of becoming partner.**

**Unpopularity of options.**

# **FUNDAMENTAL QUESTION: DOES SECTION 83 APPLY?**

---

**Does section 83 apply to some or all partnership interests and options granted to employees?**

- **Revenue Procedures are silent on the issue, while 2005 proposed regulations would apply section 83.**
  - **Proposed regulations must bridge several disconnects between subchapter K and section 83.**
- **Section 83 underlies the carried interest proposals.**

# **SUBCHAPTER K AND SECTION 83 INCONSISTENCIES**

---

- **Section 83 uses discounted fair market value.**
- **Section 704(b) uses liquidation value.**
  - **If section 83 applies, but liquidation values are not used, special allocations would need to be employed to bridge the section 83/704(b) value gap.**
- **Subchapter K is retrospective, while section 83 is not.**

## **KEY ISSUES: BOOKUPS**

---

- **Bookups are crucial to preserving economics and avoiding the potential for unintended, immediately taxable capital shifts.**
- **Must occur when interests are issued and when options are exercised.**
  - **Note that bookups require reverse section 704(c) allocations.**
  - **Appraisals to Support FMV of Partnership Assets?**
    - **If not, any issue as to whether there is a pure profits interest?**
    - **Does value of interest or partnership assets govern?**

## KEY ISSUES: CAPITAL SHIFTS

---

**A capital shift occurs when a partner with a capital interest transfers the right to some or all proceeds on liquidation to another partner, e.g., an employee.**

- **Is this shift always taxable? To all old members?**
- **How is the amount of the shift measured (asset / partnership interest value)?**
- **Does increase in value as to services to be performed equal the value of interest received, so no capital shift?**
- **Bookup will reduce a capital shift when a **capital** interest is granted for services at a discount, and eliminate a capital shift when a **profits** interest is granted.**



## **KEY ISSUES: HYPOTHETICAL TRANSFER OF PARTNERSHIP ASSETS?**

---

**Question of how employee pays for a capital interest – is there a deemed cash/asset transfer?**

- **Can the deemed cash transfer model of section 1032 be used to explain payment for the interest?**
- **If a deemed asset transfer occurs, is there gain to the partnership? If so, is it allocated to the old partners?**
  - **Bookups in connection with the issuance of discounted capital interests will reduce, but not eliminate, gain.**
- **Does increase in value from services to be performed equal the value of interest received, so that any transfer is avoided?**

# KEY ISSUES: K-1 PARTNER STATUS

---

- **When an employee becomes a K-1 partner is often unclear and may depend on the type of interest issued.**
  - **Key Issue – Is W-2 withholding required on issuance of a potential capital interest to employee non-partners?**

## **CURRENT LAW: CAPITAL INTERESTS**

---

**A capital interest entitles the holder to a share of proceeds from the sale of partnership assets upon an immediate liquidation.**

- **Issuance is a taxable event to employee, with income equal to FMV/liquidation value of interest, less any employee payment for the interest.**
- **Bookup – mark interests to market to avoid unintended capital shift to employee with respect to prior appreciation in assets.**
  - **Even with bookup, there will be a capital shift to the extent the employee's initial capital account exceeds any amount paid for the interest. A bookup will generally reduce the value of the interest received and so the amount of any capital shift.**

## **CURRENT LAW: CAPITAL INTERESTS**

---

- **If the employee does not pay for the interest, what is the consideration for purchase?**
  - **How are the employee's services valued?**
  - **What value governs if the FMV of assets and interest differ?**
- **Does the partnership get a deduction or a capital expenditure under section 263?**
- **Employee becomes a K-1 partner upon issuance of the unrestricted capital interest.**

# **RESTRICTED CAPITAL INTERESTS**

---

**Key question is whether section 83 applies at issuance.**

- **If the employee can (and does) make an 83(b) election, taxable event occurs upon receipt of the restricted capital interest.**
  - **Partnership must bookup to limit capital shift; employee pays tax.**
  - **Is the value of the interest the section 83 fair market value or the section 704 liquidation value?**
  - **Gain on hypothetical asset transfer?**
  - **Is employee entitled to a loss after making an 83(b) election if the interest is forfeited before vesting? If there is a loss, is it measured by adjusted basis in interest? Capital or ordinary?**
  - **Is the employee a K-1 partner at issuance?**

# RESTRICTED CAPITAL INTERESTS

---

- **If no section 83(b) election is made, no tax to employee upon issuance (under either section 83 or section 721 regulations), so:**
  - **No bookup or special allocations required at issuance to avoid capital shift.**
  - **No gain on hypothetical asset transfer at issuance.**
  - **No deduction for partnership.**
- **With no section 83(b) election at issuance, vesting of the interest is a taxable event for employee.**
  - **Gain on hypothetical partnership asset transfer?**
  - **Bookup at vesting does not prevent the employee's taxable event, but limits its size.**

# **CURRENT LAW: PROFITS INTERESTS**

---

**Concerns in large part resolved under current law for profits interests governed by Revenue Procedures 93-27 and 2001-43.**

- **The Revenue Procedures provide a sensible construct that sidesteps intractable issues.**
- **Some practitioners initially concerned by the Revenue Procedures' failure to resolve fundamental issues.**
- **Concern abated after proposed regulations were issued.**

## **REVENUE PROCEDURE 93-27: UNRESTRICTED PROFITS INTERESTS**

---

**A Profits Interest grants no share of proceeds from sale of partnership assets upon immediate liquidation.**

- **Is a profits interest property governed by section 83?**
  - **If so, no reason to enact section 707, which governs when section 83 does not, since the two sections are mutually exclusive.**
  - **Case law is mixed –**
    - ***Diamond* and the Tax Court in *Campbell* said section 83 governs.**
    - **General Counsel Memoranda 36346 said section 83 does not apply.**
    - **8th Circuit in *Campbell* and Revenue Procedure 93-27 dodge the issue.**



## **REVENUE PROCEDURE 93-27: UNRESTRICTED PROFITS INTERESTS**

---

**Revenue Procedure 93-27 provides that the receipt of a profits interest for services is not a taxable event for the employee or the partnership, unless interest represents predictable income from partnership, the interest is disposed of within two years, or it is an interest in a publicly traded partnership.**

- **Not clear whether the Revenue Procedure reaches this result because:**
  - **section 83 applies, but profits interest is not subject to tax under section 83 because it has a zero liquidation value, or**
  - **section 83 does not apply and the profits interest has no ascertainable value, so issuance is an open transaction.**

## **REVENUE PROCEDURE 93-27: UNRESTRICTED PROFITS INTERESTS**

---

- **Query: Is a subsequent bookup, or exchange of an interest in an IPO within two years, a disposition? Does the answer depend on whether the IPO or other disposition is unknown at issuance of the interest?**
  - **If a disposition occurs, note amended return issues.**

## **REVENUE PROCEDURE 93-27: UNRESTRICTED PROFITS INTERESTS**

---

**Revenue Procedure 93-27 implicitly assumes the partnership will book up before issuance – if not, the interest is part capital, which is taxable to the employee, and the resulting capital shift may trigger gain to old partners.**

- **Bookup needs to be at the right value, but is that FMV or liquidation value?**
- **If value is too low, employee could have part-capital interest.**
- **Revenue Procedure 93-27 should apply to the part-profits interest, if the capital interest carries the same percentage of capital and profits.**

## **REVENUE PROCEDURE 93-27: UNRESTRICTED PROFITS INTERESTS**

---

- **No hypothetical sale of partnership assets if Revenue Procedure applies, because 93-27 says that a grant of profits interest does not result in a taxable event for partnership.**
  - **Does employee become a K-1 partner at issuance?**
  - **Does employee have to be treated as a partner upon issuance for income allocation purposes, consistent with Revenue Procedure 2001-43?**
- **Do the answers to these questions change if Revenue Procedure 93-27 does not apply? Or do the answers remain the same because the interest is either section 83 property that has no ascertainable value, or not property because it is merely an unfunded promise to pay in the future?**

## REVENUE PROCEDURE 2001-43: RESTRICTED PROFITS INTERESTS

---

Until 2001, it was unclear whether Revenue Procedure 93-27 covered the issuance of restricted profits interests.

- Revenue Procedure 2001-43 clarifies that a restricted interest that satisfies the requirements of Revenue Procedure 93-27 is treated as received when issued, and neither issuance nor vesting will be treated as a taxable event to the employee or the partnership, **as long as** the employee is **treated as a member** for income allocation purposes **from the date of issuance** and the **partnership claims no deduction** with respect to the interest at issuance or vesting.
- The employee must share in the partnership's profits before vesting in order for Revenue Procedure 2001-43 to apply.

## **REVENUE PROCEDURE 2001-43: RESTRICTED PROFITS INTERESTS**

---

- **Revenue Procedure 2001-43 does not say whether section 83 applies to restricted profits interests, but hints that it may not apply since it provides that employees need not file an 83(b) election.**
  - **Employees still file 83(b) elections with zero value – why?**
  - **Worried that Revenue Procedure 2001-43 would not apply? Or that the Revenue Procedure could be withdrawn?**
  - **Any change in behavior after 2005 proposed regulations were issued?**

# **REVENUE PROCEDURE 2001-43 AND ISSUANCE OF RESTRICTED PROFITS INTERESTS**

---

- **Partnership must bookup at issuance to avoid the employee receiving a part-capital interest per Revenue Procedure 93-27.**
  - **If no bookup at issuance, tax to the employee and other partners on issuance of deemed capital interest as a result of capital shift.**
  - **If the values are not spot on, Revenue Procedure 2001-43 should apply to the profits interest as long as the capital interest entitles the holder to the same percentage of capital and profits.**

## **QUESTIONS REGARDING REVENUE PROCEDURE 2001-43**

---

- **No need to book up at vesting because it is a non-event for tax purposes.**
- **No hypothetical asset sale because Revenue Procedure 2001-43 says no tax to partnership at issuance or vesting.**
- **Query: Loss to employee if interest is forfeited before / after vesting? Is any loss measured by adjusted basis? Is it ordinary or capital?**
  - **Can partners with no section 752 debt allocation abandon interests and claim ordinary loss?**



## **RESTRICTED PROFITS INTERESTS NOT COVERED BY REVENUE PROCEDURE 2001-43**

---

**If Revenue Procedure 2001-43 does not apply, is there an argument that there is no tax upon receipt or vesting of a restricted profits interest because it has a zero liquidation value and/or is a mere unfunded promise to pay?**

- Note that if there is no tax at issuance, any income allocated to an employee before vesting is likely taxable as ordinary compensation income.**

## **2005 PROPOSED REGULATIONS**

## 2005 PROPOSED REGULATIONS

---

The 2005 proposed regulations provide that section 83 governs both capital and profits compensatory partnership interests issued to a partner providing services to the **issuing** partnership.

The proposed regulations make the following significant section 83-related amendments to the subchapter K regulations:

- conform the subchapter K timing rules to the section 83 rules;
- revise the section 704(b) regulations to address potentially transitory allocations with respect to a restricted interest (which may be forfeited); and
- revise the section 721 regulations to provide that a partnership generally does not recognize gain or loss when it issues a compensatory partnership interest.

## **2005 PROPOSED REGULATIONS**

---

**The proposed regulations do not govern a bare right to receive allocations and distributions from a partnership described in section 707(a)(2)(A), because such a right does not constitute a partnership interest.**

- **Excepting these payments from section 83 treatment creates considerable uncertainty regarding the scope of the proposed regulations.**
- **When a service provider's interest should be treated as a partnership interest (and so subject to the proposed regulations) appears to turn on entrepreneurial risk, although this result is not clear.**

# **2005 PROPOSED REGULATIONS**

---

## **No Partnership Gain on Compensatory Interest Transfers**

- **Partnerships generally will not be subject to tax in connection with the issuance or substantial vesting of a compensatory partnership interest.**
- **The preamble to the proposed regulations confirms that protecting partnerships from gain recognition is generally consistent with the policies underlying section 721.**

# **2005 PROPOSED REGULATIONS**

---

## **Partnership Compensation Deductions**

- **The proposed regulations treat compensatory partnership interests issued to partners as guaranteed payments, but note that section 83 principles will govern the timing of a service provider's income inclusion and the partnership's deduction, if, and to the extent, section 83 conflicts with the subchapter K timing rules for guaranteed payments.**
- **Thus, the partnership may claim a deduction in the partnership's taxable year that includes the end of the service provider's taxable year in which the provider reports compensation income.**

## **2005 PROPOSED REGULATIONS**

---

- **Separate section 83(b) elections must be made for each actual grant of a separate compensatory interest, but fluctuations in the value of a single interest should not require additional elections.**
- **The government has requested comments regarding the section 83 treatment of retroactive transfers of partnership interests and what, if any, actions may be appropriate to address the associated administrative concerns.**

## **2005 PROPOSED REGULATIONS**

---

### **Consequences of Section 83(b) elections for unvested compensatory partnership interests:**

- **Making a section 83(b) election for an unvested capital or profits interest will cause the service provider to be treated as a partner for all income tax purposes.**
- **Making a section 83(b) election with respect to an unvested profits interest under the liquidation safe harbor will typically protect the service provider from income and deny the partnership a corresponding compensation deduction.**
- **By contrast, if a section 83(b) election is not made for an unvested profits interest, the service provider will not be treated as a partner until the interest vests, at which point he or she would recognize ordinary compensation income equal to the then-fair market value of the interest.**



# **2005 PROPOSED REGULATIONS**

---

## **Valuation of Compensatory Partnership Interests**

- **Section 83 generally requires the recipient of a vested compensatory partnership interest to recognize income equal to the fair market value of the interest, calculated by disregarding any lapse restrictions.**
- **The service provider's capital account is increased by the amount he or she includes in income under section 83, plus any amount he or she pays for the interest.**

## **2005 PROPOSED REGULATIONS**

---

**The proposed regulations create an elective safe harbor (described in detail in Notice 2005-43), under which the value of compensatory partnership interests may be determined for section 83 purposes based on liquidation value.**

- **To qualify for the liquidation value safe harbor, a partnership's agreement must contain "legally binding" provisions that:**
  - **"authorize and direct" the partnership to elect the safe harbor, and**
  - **obligate all partners (including any service provider receiving an interest, and any transferees of interests) to comply with all safe harbor requirements while the safe harbor election remains in effect.**
- **These procedural requirements effectively require unanimous partner consent.**

## 2005 PROPOSED REGULATIONS

---

The liquidation safe harbor is not available for partnership interests related to assets that generally produce a substantially certain stream of income, such as high quality fixed income securities, or interests transferred in anticipation of a subsequent disposition.

- absent **clear and convincing evidence** to the contrary, a partnership interest will be assumed to be transferred in anticipation of a subsequent disposition if the interest is, in fact, sold or disposed of, **or is puttable or callable**, within two years of receipt (other than by reason of death or disability of the service provider).
- This put/call presumption may exclude most interests issued by hedge funds from the safe harbor.

## 2005 PROPOSED REGULATIONS

---

- The liquidation safe harbor benefits profits interest holders, producing a zero value for most unvested pure profits interests for which section 83(b) elections are made.
- By contrast, the liquidation value safe harbor disadvantages recipients of capital interests, because it precludes the use of valuation discounts for illiquidity, minority interests, etc.
  - The election procedures seek to prevent a (higher) liquidation value partnership deduction for a capital interest and (lower) fair market value on section 83(b) election for the interest.
  - Absent the ability to make a safe harbor election, the age-old question of whether the grant (or vesting) of a profits interest produces taxable income for a service provider will arise.

## **2005 PROPOSED REGULATIONS**

---

- **If a section 83(b) election is made with respect to an unvested interest, the recipient will immediately be treated as a partner and will be allocated partnership items that he or she could later forfeit. The potentially transitory nature of these allocations means they cannot have economic effect.**
- **Allocations to a partner holding an unvested interest will only be treated as in accordance with the partner's interest in the partnership for section 704(b) purposes if:**
  - **the partnership agreement requires the partnership to make “forfeiture allocations” upon the forfeiture of an unvested interest, and**
  - **all material allocations and capital account adjustments under the partnership agreement pertaining to vested partnership interests comply with section 704(b).**

## 2005 PROPOSED REGULATIONS

---

- **Forfeiture Allocations:** A forfeiting partner must generally be allocated available items of partnership gross income and gain, or gross deduction and loss, to the extent necessary to offset prior distributions (including deemed distributions under section 752(b)) and allocations of partnership items with respect to the forfeited partnership interest, to the extent such items exceed the amounts paid for, or contributed with respect to, the forfeited interest, including deemed contributions under section 752(a).
- **Notional Reversal of Loss Allocations:** If a partnership's gross income and gain in the year of a forfeiture is insufficient to fully offset prior loss allocations, the forfeiting partner must recapture any remaining previously allocated losses as phantom income. Since such recaptured losses cannot be reallocated, the partnership would effectively forfeit a deduction for any such losses.

## 2005 PROPOSED REGULATIONS

---

- **Incomplete Reversal of Income Allocations:** By contrast, if a partnership's deductions and losses are insufficient to fully offset prior allocations of income to the forfeiting partner, the preamble cautions that section 83(b)(1) "appears to" prohibit the service provider from claiming a corresponding (ordinary) phantom loss to offset previously allocated partnership income.
  - Thus, the partner would be limited to claiming a capital loss with respect to any remaining basis in his or her forfeited partnership interest.
  - Query: At most, shouldn't the loss prohibition be limited to the value referenced on the section 83(b) election?

## **TAXATION OF CARRIED INTERESTS: CURRENT LEGISLATIVE PROPOSALS**



# **WHY CHANGE HOW CARRIED INTERESTS ARE TAXED?\***

---

**Legislative proposals to tax carried interests as ordinary income date back five years. Why change things now?**

- **Focus on spending offsets and deficit reduction – current Obama Administration’s proposal estimated to raise \$13.496 billion over 10 years.**
- **Treasury support for ordinary income tax on carried interests.**
- **Growing perception of unfairness.**

**\* My thanks to Jim Sowell, Shane Stroud and Shelly Banoff for their invaluable insights on this topic.**

# WHY CHANGE HOW CARRIED INTERESTS ARE TAXED?

---

**“Long term venture capital investment is a critical component to our success. Without the risk capital and business expertise provided by these professionals over many years, the ability to grow our companies and innovate would be seriously compromised. Yet, a proposal to double the taxes on venture capitalists will discourage this critical investment at a time when we need it the most. . . . When policy makers double the tax on certain activities, the message is clear: They want to discourage that type of behavior. We have seen this type of policy before in areas such as tobacco use. Does government really want less venture capital investment at a time when our country is in desperate need of it? Does venture capital investment fall into the same category as tobacco use?”**

**May 18, 2010 Letter from the National Venture Capital Association to Members of Congress**

# WHY CHANGE HOW CARRIED INTERESTS ARE TAXED?

---

**“If you’re in the luckiest 1% of humanity, you owe it to the rest of humanity to think about the other 99%. . . . If you run a partnership and you have capital gains, you have a 15% tax rate; and if you run a corporation and have capital gains, you have a 35% tax rate. When both entities are operating in a similar manner with many thousands of shareholders, freely tradable shares, people managing them who are attempting to evaluate investments, it seems a bit illogical to have that sort of a spread in the tax rate just depending on form.”**

**Investor Warren Buffett**

## 2012 HOUSE BILL

# INVESTMENT SERVICES PARTNERSHIP INTERESTS

---

**In February 2012, Congressman Sander Levin introduced “The Carried Interest Fairness Act of 2012” in the U.S. House of Representatives.**

- **A similar bill was passed by the House on December 9, 2009; House and Senate negotiators circulated a jointly amended Senate amendment to H.R. 4213 on May 20, 2010, but the legislation was never voted on by the Senate.**
- **The Levin bill would add new Code section addressing the treatment of investment services partnership interests (“ISPIs”).**

# INVESTMENT SERVICES PARTNERSHIP INTERESTS

---

- **The Levin bill would amend section 83 to provide that:**
  - **the value of an ISPI received in connection with the performance of services for or on behalf of a partnership equals its liquidation value at the time of transfer, and**
  - **the person receiving the ISPI will be treated as making a section 83(b) election, unless he or she affirmatively elects not to.**
- **Would apply to ISPIs transferred after the date of enactment.**

## DEFINITION OF ISPIs

---

**New section 710 addresses the treatment of investment services partnership interests (ISPIs), which are interests in an investment partnership held direct or indirect by any person who would be reasonably expected when acquiring the interest to provide, either directly or indirectly through a related party, a substantial quantity of any of the following services with respect to assets held directly or indirectly by the partnership:**

- **advising as to the advisability of investing in, purchasing, or selling any **specified asset**, e.g., securities, real estate held for rental or investment, interests in partnerships, commodities, or options or derivative contracts on the above,**
- **managing, acquiring, or disposing of a specified asset,**
- **arranging financing to acquire specified assets, and**
- **any activity in support of any service described above.**

# DEFINITION OF INVESTMENT PARTNERSHIP

---

**New section 710 defines an “investment partnership” as a partnership with respect to which, as of the end of any calendar quarter ending after the date of enactment:**

- **substantially all of its assets (determined without regard to any section 197(d) intangible assets, e.g., goodwill, going concern value) are specified assets; and**
- **more than half of its capital is attributable to qualified capital interests which (in the hands of the owners of such interests) do not constitute property held in connection with a trade or business.**



## **ISPI RELATED PARTIES**

---

**The Levin bill's broad definition of related parties by reference to sections 267 and 707(b) appears to include the following entities and individuals providing services in typical fund structures:**

- **Sponsors**
- **GPs**
- **Service Partners in Funds, GPs and Affiliates**

**Accordingly, all income of affiliates held through a partnership ISPI would be effectively subject to tax under section 710.**

# ISPI NET INCOME AND LOSS

---

## **ISPI Net Income and Loss:**

- **A partner's distributive share of ISPI net income is recharacterized as ordinary income, subject to self-employment tax, regardless of whether the income would otherwise be treated as capital gain, dividend income, or any other type of income in the hands of the partner, except to the extent attributable to the partner's "qualified capital interest."**
- **A partner's distributive share of ISPI net losses is treated as an ordinary loss, but is only allowed to the extent of net income previously taken into account. Disallowed losses may be carried forward to the next taxable year.**
  - **No downward basis adjustment in partnership interest until losses are allowed.**

## **ISPI NET INCOME – 2012 AND 2010 LEVIN BILLS**

---

**The 2012 Levin bill would tax all of a partner's distributive share of ISPI net income as ordinary income.**

**By contrast, the Senate amendment to the 2010 Levin bill would have treated ISPI net income as 75% ordinary income and 25% capital gain starting in 2013.**

- Phase-in from date of enactment through 2012 (e.g., 50% ordinary income and 50% capital gains for taxable years beginning before January 1, 2013).**
- It was unclear whether this allocation would have been available for individuals holding ISPIs through intervening entities.**

# ISPI DISPOSITION CONSEQUENCES

---

- **Gain from any disposition of an ISPI is generally treated as ordinary income from the sale of inventory and recognized notwithstanding any provision that would otherwise permit deferral or avoidance, e.g., non-recognition transfers.**
- **Net loss from any disposition of an ISPI is treated as an allowable ordinary loss to the extent prior net income has been taxed as ordinary income in excess of ordinary losses, with proration if only part of the interest is disposed of.**
- **Basis attributable to suspended net losses will produce only capital loss on disposition of an ISPI.**

# ISPI DISPOSITION CONSEQUENCES

---

- **When an ISPI is disposed of by gift or by reason of the death of the taxpayer, gain is not treated as ordinary income, but the ISPI remains an ISPI in the hands of the acquiror.**
- **In the case of death, the amount that would have been treated as ordinary income upon the sale of the ISPI by the decedent immediately before death is treated as an item of income in respect of a decedent under section 691.**
- **No basis step up at death allowed with respect to an ISPI of a decedent, as it constitutes a right to receive an item of income in respect of a decedent.**

# ISPI DISTRIBUTION CONSEQUENCES

---

**A distribution of appreciated partnership property with respect to an ISPI is treated as a deemed sale of the property at FMV, with allocation of resulting gain as ordinary income to recipient, and deemed distribution of the cash proceeds of the notional sale to recipient.**

- **Recipient will recognize additional gain if the deemed cash distribution exceeds basis in partnership interest after adjustment for consequences of deemed sale.**
- **Recipient receives FMV property basis.**
- **Provision renders partnership mergers taxable to ISPI holders.**

# **SEPARATE AND VERIFIABLE GOODWILL EXCLUSION**

---

**The 2012 Levin bill excludes from ordinary income treatment sales proceeds attributable to any “clearly separate and verifiable goodwill” on the sale of an interest in a non-investment partnership that holds ISPIs.**

- An example in the Technical Explanation provides that the sale of a management entity that holds ISPIs, and also possesses separate goodwill, will produce capital gain with respect to consideration attributable to goodwill (or other non-ISPI assets), and ordinary income with respect to the balance of the consideration attributable to the ISPIs.**
- Goodwill would not include ISPI value attributable to future carry, which would generate ordinary income.**

# SEPARATE AND VERIFIABLE GOODWILL EXCLUSION

---

- The allocation of proceeds between goodwill and ISPIs would apparently be covered by new section 710(b)(7), which provides that “the Secretary shall prescribe regulations or other guidance which provide the acceptable methods for valuing [ISPIs] for purposes of this section.”
- It is not clear from the Bill text or Technical Explanation whether separate and identifiable goodwill could be established on a direct sale of an ISPI.
  - Press release from Congressman Levin indicates his office is working with the Joint Committee on Taxation to determine whether additional structures or facts and circumstances can produce such separate and verifiable goodwill.



## **QUALIFIED CAPITAL INTERESTS EXCLUDED**

---

**The Levin bill excludes “qualified capital interests,” which is the portion of a service provider’s interest in a partnership that is acquired by the service provider through investment and is not entitled to preferential allocations.**

- **A qualified capital interest may include the portion of any partnership interest attributable to:**
  - **the fair market value of money and other property actually contributed (no credit for section 752 deemed contributions),**
  - **amounts included in gross income with respect to the transfer of such interest under section 83, and**
  - **the amount of any net income or gain allocated to an ISPI, reduced by net allocable losses and post-effective date distributions.**

# EXCEPTIONS TO QUALIFIED CAPITAL INTEREST DEFINITION

---

**The exception for qualified capital interests is not available:**

- **for an ISPI with respect to which allocations are not made in the same manner as significant allocations to non-service partners.**
  - **Treasury to provide guidance regarding permitted allocations when all partners provide services.**
- **for an ISPI acquired by a service providing partner that is funded by a loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or by a person related to that other partner or the partnership).**

# ISPI ANTI-AVOIDANCE PROVISIONS

---

**Anti-avoidance provisions capture disguised ISPI (“disqualified”) interests that service providers may receive, including:**

- **any interest in the entity other than debt,**
- **convertible or contingent debt of the entity,**
- **any option or other right to acquire property described above, and**

## ISPI ANTI-AVOIDANCE PROVISIONS

---

- **any derivative instrument entered into (directly or indirectly) with the entity or any investor in the entity, other than a partnership interest and, except as provided by the Secretary, an interest in a “taxable corporation” or stock in an S corporation.**
- **A “taxable corporation” means a domestic C corporation or a foreign corporation substantially all of the income of which is either effectively connected with the conduct of a U.S. trade or business or is subject to a comprehensive foreign income tax (as defined in section 457A(d)(2)).**

# ISPIs IN PUBLICLY TRADED PARTNERSHIPS

---

**Income from ISPIs generally will not constitute “qualifying income” for purposes of the publicly traded partnership rules, but publicly traded partnerships on the date of enactment are grandfathered for 10 years.**

- The 2012 Levin bill deletes the 2010 Levin bill provision providing an exception for an individual’s disposition of an ISPI in a publicly traded partnership with respect to which neither such individual nor any member of such individual’s family had at any time provided any proscribed services with respect to assets held directly or indirectly by such publicly traded partnership.**

# ISPI MISCELLANEOUS PROVISIONS

---

## **Miscellaneous ISPI provisions:**

- **Limited exceptions apply for REITs and certain other partnerships whose income is all ordinary income and section 1231 gain (property used in a trade or business and involuntary conversion property).**
- **Specific 40% penalty for holding disguised ISPIs absent disclosure, substantial authority, and a reasonable belief that the claimed (non-ISPI) treatment was more likely than not to be proper.**

## **EFFECTIVE DATE(S) FOR 2012 LEVIN BILL**

---

- **In general, legislation will apply to partnership taxable years ending after the date of enactment.**
  - **For any partnership taxable year which includes the date of enactment, section 710(a) will apply only to the lesser of the ISPI capital gain (i) for the entire partnership taxable year, or (ii) determined by taking into account only items attributable to the post-enactment portion of the taxable year.**
- **Legislation will apply to dispositions and distributions occurring after the date of enactment.**
- **Anti-abuse rules apply as of the date of enactment.**

# **FISCAL YEAR 2013 TREASURY PROPOSAL**



# **FISCAL YEAR 2013 TREASURY PROPOSAL**

---

**The Obama Administration has also proposed that carried interests be taxed at ordinary income tax rates.**

- Estimated to raise \$13.496 billion over the next 10 years.**
- The Greenbook clarifies that a partner's share of income on an ISPI would be subject to tax at ordinary rates and the partner would be required to pay self-employment taxes on ISPI income.**
- Gain recognized on the sale of the ISPI would also generally be taxed as ordinary income.**
- The Greenbook notes that “[t]o ensure more consistent treatment with the sales of other types of businesses, the Administration remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the ISPI holder.”**

## **FY 2013 TREASURY PROPOSAL – ISPI DEFINITION**

---

**An ISPI for purposes of the FY2013 Treasury Proposal is a carried interest in an “investment partnership” that is held by a person who provides services to the partnership.**

- A partnership is an “investment partnership” if substantially all of its assets are investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets), but only if over half of the partnership’s contributed capital is from partners in whose hands the interests constitute property held for the production of income.**

## **FY 2013 TREASURY PROPOSAL – ISPI DEFINITION**

---

- **To the extent the partner who holds an ISPI contributes “invested capital” (which is generally money or other property) to the partnership and receives a “qualified capital interest”, income attributable to the invested capital would not be recharacterized. Similarly, the portion of any gain recognized on the sale of an ISPI that is attributable to the invested capital would be treated as capital gain.**
- **For a capital interest to be a “qualified capital interest”, the partnership allocations with respect to the invested capital must be made in the same manner as allocations with respect to other capital interests held by partners who do not hold an ISPI and the allocations made to non-ISPI holders must be significant.**
- **“Invested capital” will not include contributed capital that is attributable to the proceeds of any loan or other advance made or guaranteed by any partner or the partnership.**

## **FY 2013 TREASURY PROPOSAL – ISPI DEFINITION**

---

- **Any person who performs services for an entity and holds a “disqualified interest” in the entity is subject to tax at rates applicable to ordinary income on any income or gain received with respect to the interest.**
  - **A “disqualified interest” is defined as convertible or contingent debt, an option, or any derivative instrument with respect to the entity (but does not include a partnership interest, stock in certain taxable corporations, or stock in an S corporation).**
- **Proposal is not intended to adversely affect qualification of a REIT owning a carried interest in a real estate partnership.**

# COMPARISON OF LEGISLATIVE PROPOSALS

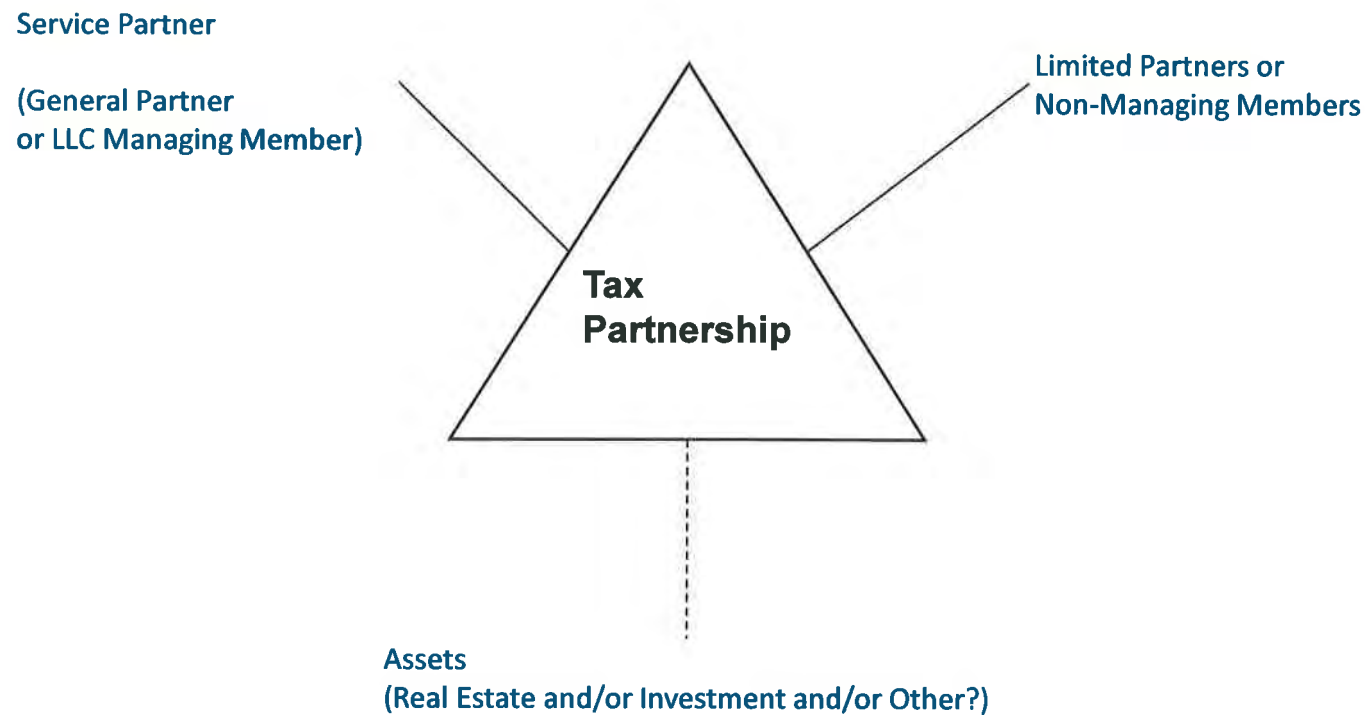
	2012 Levin Bill	FY 2013 Administration Proposal
<b>Coverage</b>	Covers "Investment Services Partnership Interest" – received in exchange for provision of services with respect to specified assets.	Covers "Investment Services Partnership Interest" – received in exchange for provision of services with respect to "investment-type" assets.
<b>Income</b>	Income generated from ISPI would generally be taxed as ordinary income.	Income generated from ISPI would be taxed as ordinary income.
<b>Losses</b>	Limited ordinary losses	No loss provision
<b>Distributions</b>	Deemed sale mechanic	No discussion
<b>Goodwill Exclusion</b>	Excludes sales proceeds attributable to "separate and verifiable goodwill" on sale of an interest in a partnership that is not an investment partnership, but holds ISPIs.	Commitment to develop mechanism for proper amount of income recharacterization where business has goodwill or other assets unrelated to the services of the ISPI holder.
<b>Excepted Capital Interests</b>	Broader definition	Narrower definition
<b>Penalties</b>	40% penalty	No discussion
<b>Effective Date</b>	Generally effective for tax years ending after date of enactment.	Tax years ending after December 31, 2012.
<b>Estimated Revenue</b>	No estimate available	\$13.496 billion over 10 years

## **CARRIED INTERESTS: DISCUSSION MODELS\***

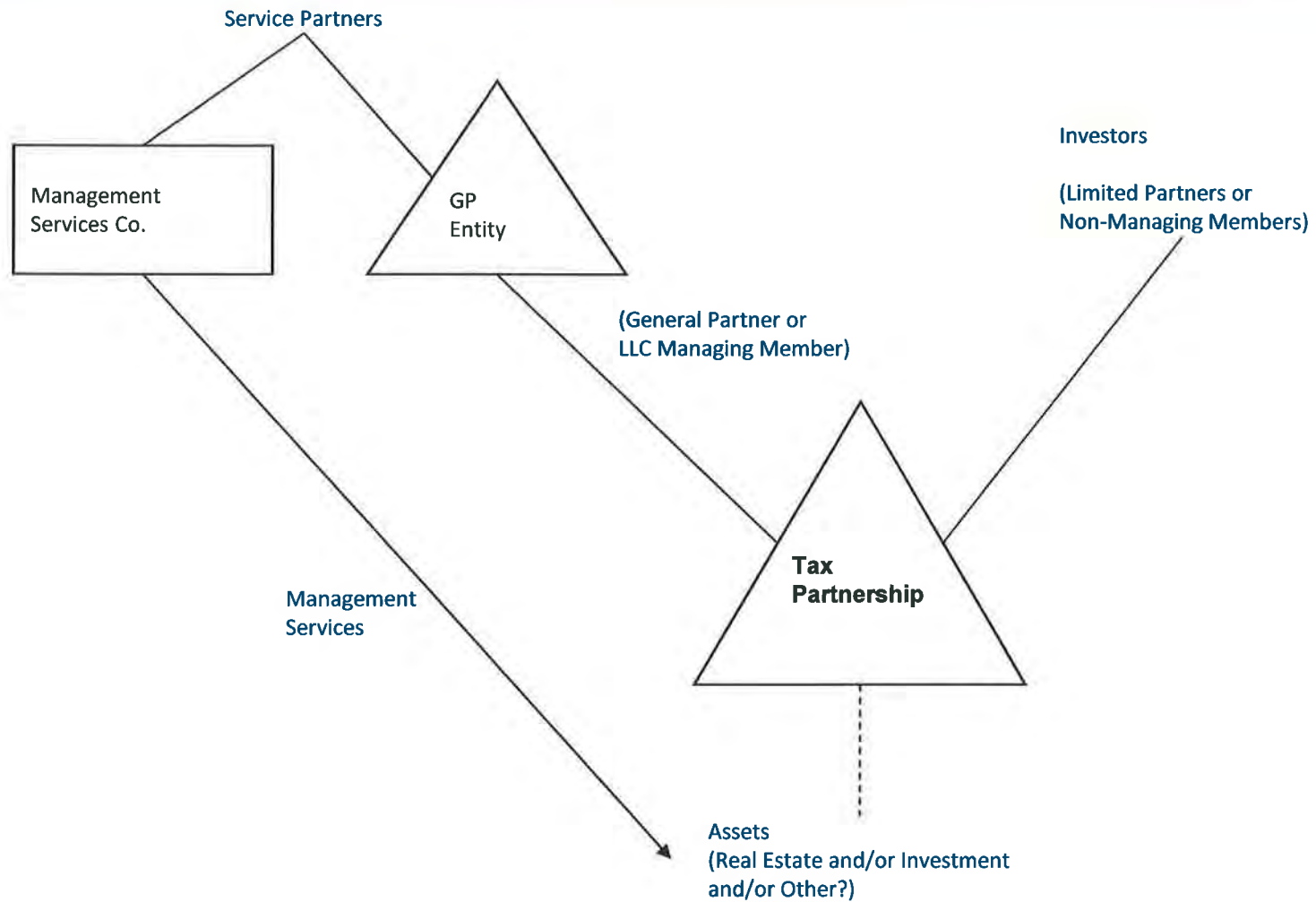
**\* Contributed by Shelly Banoff**

# BASIC MODEL

---



# MULTI-TIER TAX PARTNERSHIPS





# MULTI-TIERED TAX PARTNERSHIP WITH EMPLOYEE CO-INVESTORS & SERVICE PARTNER AFFILIATED WITH FUND GENERAL PARTNER

---

