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Senate Finance Committee Chairman Ron Wyden (D-OR) Introduces the “Ending The Carried Interest Loophole Act” That Would Require Current Ordinary Income Inclusions

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On August 5, 2021, U.S. Senate Finance Committee Chairman Ron Wyden (D-Oregon) and U.S. Senate Finance Committee member Sheldon Whitehouse (D-Rhode Island) introduced legislation entitled the “Ending the Carried Interest Loophole Act.”[1] According to a summary released by the Finance Committee, the legislation is intended to close “the entire carried interest loophole.” While this legislation is very similar to a previous proposal introduced by Chairman Wyden[2], this legislation appears to have a greater likelihood of passage given the Democratic party’s control of both chambers of Congress and the election of President Biden. The legislation may have an even greater chance of passage if it secures the support of moderate Democratic Senators who will be key to its passage through reconciliation, which is a technical procedure that would permit Democrats to pass the bill through a majority vote in the Senate.

The “Ending the Carried Interest Loophole Act” would require partners who hold carried interests in exchange for providing services to investment partnerships to recognize a specified amount of deemed compensation income each year regardless of whether the investment partnership recognizes income or gain and regardless of whether and when the service providers receive distributions in respect of their carried interests. This deemed compensation income would be subject to income tax at ordinary income rates and self-employment taxes.

This legislation goes well beyond many previously proposed bills that attempted to recharacterize certain future income from investment partnerships as ordinary income instead of capital gain. In addition, it would replace section 1061 of the Internal Revenue Code of 1986, as amended (the “Code”), which was enacted as part of the 2017 tax act,[3] and lengthened the required holding period from one year to three years for service providers to recognize long-term capital gain in respect of carried interests.

Current Treatment of “Carried Interest” Allocations

Under current law, a partnership generally can issue a partnership “profits interest” to a service provider without current tax. The service provider holds the interest as a capital asset, with both the timing of recognition and character of the partner’s share of profits from the partnership determined by reference to the timing of recognition and character of profits made by the partnership. Thus, if the partnership recognizes capital gain, the service provider’s allocable share of the gain generally would be capital gain and recognized in the same year as the partnership’s recognition of the capital gain. These partnership “profits interests” are referred to as “carried interests” in the private equity

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context, “incentive allocations” in the hedge fund context, or “promotes” in the real estate context. As noted above, Code section 1061 generally treats gain recognized with respect to certain partnership interests held for less than three years as short-term capital gain.

“Ending the Carried Interest Loophole Act”

The legislation introduced by Chairman Wyden and Senator Whitehouse generally would require a taxpayer who receives or acquires a partnership interest in connection with the performance of services in a trade or business that involves raising or returning capital and investing in or developing securities, commodities, real estate and certain other assets to recognize annually, on a current basis – (1) a “deemed compensation amount” as ordinary income and (2) an equivalent amount as a long-term capital loss.

The “deemed compensation amount” generally would equal the product of (a) an interest charge, referred to as the “specified rate,”[4] (b) the service provider’s maximum share of partnership profits, and (c) the partnership’s invested capital as of certain measurement dates.[5] Conceptually, the partnership is viewed as investing a portion of its capital on behalf of the service provider via an interest free loan to the service provider. The service provider is deemed to recognize ordinary self-employment income in an amount equal to the foregone interest, calculated at the “specified rate.” Although not clear, the “specified rate” appears designed to approximate the economics of the typical preferred return rate often paid to limited partners on their contributed capital before the service provider receives any distributions from the partnership.

The offsetting long-term capital loss appears to be a proxy for tax basis that is designed to avoid a “double-counting” of income when the service provider ultimately receives allocations of income from the partnership attributable to the sale or disposition of partnership assets (or income or gain attributable to the sale or disposition of the partnership interest itself).[6] The long-term capital loss generally would only be usable in the tax year of deemed recognition if the individual taxpayer recognizes other capital gain that is available to be offset (otherwise, the long-term capital loss would be available to be carried forward to subsequent tax years).

For example, if a service provider is entitled to receive up to 20 percent of an investment fund’s profits, the investment fund receives $1 billion in capital contributions, and the “specified return” for the tax year is 12 percent, the service provider’s “deemed compensation amount” for that tax year would be $24,000,000, and the service provider would recognize an offsetting long-term capital loss of $24,000,000. Assuming relevant income thresholds are already met and that the service provider has sufficient long-term capital gain in the year of inclusion against which the long-term capital loss may be offset, based on maximum individual rates under current law, the service provider would expect to incur an incremental U.S. federal income tax rate of 17% on the “deemed compensation amount” (that is, 37 percent ordinary income tax rate less the 20 percent long-term capital gain tax rate).[7] Any long-term capital gain recognized by the service provider in excess of the “deemed compensation amount” that is attributable to the sale or disposition of partnership assets (or income or gain attributable to the sale or disposition of the partnership interest itself) would be taxed at 20 percent (or 23.8 percent if the net investment income tax is applicable).

To prevent a work-around, the legislation also would apply to any service provider who has received a loan from the partnership, from any other partner of the partnership, or from any person related to the partnership or another partner, unless the loan is fully recourse or fully secured and requires payments of interest at a stated rate not less than the “specified return.”

Other Proposed Changes and Contrast with Recent Biden Proposal

Besides the current inclusion of “deemed compensation amounts” at ordinary income rates, the legislation would alter existing law in several ways. As background, current

Code section 1061 generally requires a partnership to hold capital assets for three years in order for the related capital gain to be taxed at preferential long-term capital gain rates. Earlier this year, the Administration released its fiscal year 2022 Budget, including a Greenbook with detailed proposals for changes to the federal tax law.[8] Among other things, the Greenbook proposal would eliminate the ability for partners whose taxable income (from all sources) exceed $400,000 to recognize long-term capital gain with respect to these partnership "profits interests," but partners whose taxable income do not exceed $400,000 would continue to be subject to Code section 1061.

Under the bill, Code section 1061 would be repealed. In other words, ordinary income treatment would apply regardless of holding period and regardless of the service provider's level of taxable income. Second, like the Greenbook proposal, under this legislation – (1) the recharacterized amount would be treated as ordinary income rather than short-term capital gain (there is currently no rate differential, but there could be sourcing and other differences), and (2) the "deemed compensation amount" would be subject to self-employment tax.

In addition, this bill also would provide for a deemed election under Code section 83(b) in the event of a transfer of a partnership interest in connection with the performance of services, unless the taxpayer makes a timely election to not have the deemed election apply. Unless a service provider elects out of the deemed election, the service provider would be required to recognize taxable income at the time of the transfer of a partnership interest in connection with the performance of services in an amount equal to the partnership interest's fair market value. Importantly, fair market value for this purpose would equal the distributions that the service provider would receive in the event of a hypothetical liquidation of the partnership's assets for cash (after satisfying applicable liabilities) at the time of transfer. This valuation methodology is broadly consistent with current law.

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[1] Ending the Carried Interest Loophole Act, S. 2617, 117th Cong. (2021).

[2] Ending the Carried Interest Loophole Act, S. 1639, 116th Cong. (2019).

[3] The 2017 tax act, commonly known as the Tax Cuts and Jobs Act, is formally titled "An act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Pub. L. No. 115-97, 131 Stat. 2045.

[4] The "specified rate" for a calendar year means the par yield for "5-year High Quality Market corporate bonds" for the first month of the calendar year (currently 1.21%), plus 9 percentage points.

[5] According to a summary prepared by the Senate Finance Committee, the legislation is not intended to treat an applicable percentage as higher in a given taxable year due to the application of a "catch-up" provision in the partnership agreement. In addition, a partner's "invested capital" is intended to equal the partner's book capital account maintained under the regulations under Code section 704(b) with certain modifications, including that invested capital is to be calculated without regard to untaxed gain and loss resulting from the revaluation of partnership property.

[6] Even though the long-term capital loss may be used to offset other capital gain income of the service provider, the legislation would still fulfill its intended purpose of ensuring that the "deemed compensation amount" is subject to tax at ordinary income rates.

[7] For simplicity, we have omitted self-employment tax from the computation of the "deemed compensation amount" and omitted net investment income tax from the offsetting capital loss benefit on the assumption that these will generally offset.

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[8] The proposed changes are described here: https://www.gibsondunn.com/biden-administration-releases-fiscal-year-2022-budget-with-greenbook-and-descriptions-of-proposed-changes-to-federal-tax-law/.

Gibson Dunn lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Tax practice group, or the following authors:

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