Proposed Legislation Would Increase Tax on Carried Interest, Target Perceived Tax Abuses, and Renew Tax Incentives

On May 20, 2010, the House Ways and Means Committee and the Senate Finance Committee released the text of new legislation that would include important changes in the way partners with "carried interests" in investment partnerships are taxed, along with other significant "loophole closing" changes to the Internal Revenue Code, and other amendments. The proposed legislation, the "American Jobs and Closing Tax Loopholes Act of 2010," H.R. 4213 (the Bill), would renew several expiring tax incentives and enact new provisions intended to promote job creation. To offset these costs, among other provisions, the Bill would:

- tax 75% of income (50% until 2013) attributable to a "carried interest" in an investment services partnership as ordinary income, even if it would otherwise have qualified as long-term capital gain;
- subject certain partners and S corporation shareholders to self-employment tax on their distributive shares of income; and
- target several structures and transactions in the corporate and international arenas identified by Congress as potentially abusive.

Selected major provisions of the Bill are summarized in more detail below.

1. Carried Interest Provisions.

Many private investment fund managers receive partnership interests representing a share of future profits from assets under management (carried interests). Under current law, the character of income attributable to a carried interest is determined at the partnership level and flows through to the carried interest holders. Accordingly, a significant portion of the income recognized by fund managers in respect of a carried interest is often treated as capital gain, which, for individuals, may be taxable at lower rates than ordinary income.

Overview of new rules. The proposals with respect to carried interest in the Bill include significant changes from other proposed legislation introduced in Congress over the past three years.

Under the Bill, a percentage of net income allocated to a partner with respect to an "investment services partnership interest" (ISPI) would be treated as ordinary income, even if it otherwise would have qualified as capital gain. For individuals, the applicable percentage generally would be 75 percent (50 percent for tax years beginning prior to January 1, 2013). For all other taxpayers, 100 percent of such income would be characterized as ordinary income. In most cases, the applicable percentage of any gain realized on the disposition of an ISPI also would be taxed as ordinary income, even if the disposition would otherwise qualify for tax-free treatment (although exceptions apply to permit certain otherwise tax-free dispositions to continue to qualify for tax-free treatment). In addition, built-in gain in property distributed in kind with respect to an ISPI would be taken into account as additional ordinary income from the partnership. The use of losses allocable to an ISPI would be limited under the Bill; for the most part, such losses would be allowed only to the extent of prior net income with respect to the ISPI (with any losses that are limited carried over into subsequent tax years). These provisions would generally apply after the date of enactment.

For partnership tax years that include the date of enactment of the Bill, the new rules would apply to the amount of net income that is the lesser of (i) the net income for the entire partnership tax year or (ii) the net income attributable to the portion of the partnership tax year falling after the date of enactment.

Investment services partnership interests. The carried interests held by most private investment fund managers and sponsors will be treated as ISPIs. The Bill defines "investment services partnership interest" as any interest in a partnership held (directly or indirectly) by any person if it was reasonably expected at the time of acquisition of such interest that such person (or a related person) would provide a substantial quantity of investment management services with respect to the partnership's "specified assets." The Bill also contemplates that a partnership interest can become an ISPI at a time subsequent to its acquisition by reason of a change in the services provided with respect to assets held by the partnership. The investment services covered by the Bill include (i) providing advice with respect to decisions to invest in, purchase, or sell specified assets; (ii) managing, acquiring or disposing of specified assets; or (iii) arranging financing with respect to acquiring specified assets. The term "specified assets" is defined broadly to include securities, real estate held for rental or investment, interests in partnerships, commodities and options or derivative contracts with respect to any of the foregoing.

Qualified capital interests. Income or gain with respect to the portion of an ISPI that is a "qualified capital interest" (QCI) would not be recharacterized as ordinary income under the Bill so long as allocations to the QCI are made in a manner similar to significant allocations made to capital interests held by non-service providers. A QCI is generally defined as the portion of a partner's interest that is attributable to contributions of cash or property by the partner, allocations of partnership income to the partner, and taxable income recognized by the partner upon receipt of the partnership interest (if any). The Bill does not say what is required for allocations to be "significant" or provide alternatives for relief if significant allocations are not made to non-service providers, although it does provide for the possibility that regulations or other guidance may set forth rules under which allocations are considered properly allocable to QCIs. The exception for QCIs does not appear to apply to distributions of property.

Under special rules, interests acquired with loan proceeds may not qualify as QCIs even if they otherwise would have so qualified. A partner's interest would not be treated as a QCI if it is attributable to cash borrowed by the partner from another partner, the partnership, or a related person (or borrowed from a third party but guaranteed by any such person).

Self-employment tax. Income or gain taxed at ordinary rates under the new rules generally would be taken into account in determining self-employment tax.

Anti-avoidance provisions. The Bill includes a broad anti-avoidance provision aimed at preventing service providers from avoiding the new rules by holding interests in foreign corporations not subject to tax, holding convertible or contingent debt or options, or entering into derivatives or other arrangements that achieve returns similar to a carried interest.

Impact on certain publicly traded partnerships. Under existing law, a publicly traded partnership is generally treated as a corporation for federal income tax purposes. However, this rule does not apply to partnerships that receive predominantly passive "qualifying income." The Bill provides that items of income and gain treated as ordinary income pursuant to the rules summarized above generally would not constitute "qualifying income" of a publicly traded partnership. Exceptions would apply for certain partnerships owned by real estate investment trusts and certain partnerships owning other publicly traded partnerships. The Bill also includes a ten-year grandfathering period prior to this rule going into effect.

2. Receipt of Partnership Interests for Services.

The Bill provides helpful guidance relating to the tax treatment of the receipt of a partnership interest for services. It confirms that a person who receives a partnership interest for services would be taxed upon receipt based on its liquidation value (i.e., the amount the partner would receive in respect of the partnership interest if the partnership sold all of its assets and distributed the net proceeds to the partners in liquidation). Under this rule, a pure profits interest would be considered to be valueless. This is consistent with the manner in which pure profits interests are currently valued under IRS safe harbors. In the case of an interest subject to vesting or other forfeiture restrictions, the Bill also provides (consistent with the current IRS position under certain safe harbors) that no special election under the Internal Revenue Code (the Code) would be required to trigger taxation upon receipt; rather, such an election would be deemed to have been made in the absence of an election to the contrary.

3. Self-Employment Tax on Partners and Shareholders of Certain S Corporations.

The Bill would extend the self-employment tax rules to income earned by service providers through certain "pass-through" entities. Under the Bill, a partner of a partnership engaged in a "professional service business" would be subject to self-employment tax on the partner's share of partnership income if the partner provides substantial services with respect to the business. A "professional service business" would include investment advice or management, health, law, lobbying, engineering, architecture, accounting, actuarial science, and consulting. A shareholder of an S corporation engaged in a professional service business either directly (if the principal asset of the business is the reputation and skill of three or fewer individuals) or through a partnership would also be subject to self-employment tax on income earned through the S corporation if the shareholder provides substantial services with respect to the business.

4. International Tax Provisions.

In addition, the Bill includes several revenue raising provisions in the international arena, primarily relating to the availability of tax credits to offset U.S. taxes on foreign income, and to the sourcing rules that determine whether items are treated as arising in the United States or in a foreign jurisdiction. The provisions generally are intended to address common structures and transactions that are often utilized by multinational corporations, but that have been identified by Congress as exploiting "loopholes" in existing law.

Foreign Tax Credit Changes:

- *Foreign tax credit splitting:* The Bill would exclude from the calculation of available foreign tax credits any foreign income taxes paid or accrued with respect to foreign income that would not be included in taxable income for U.S. purposes until a subsequent taxable year. These suspended taxes would be taken into account in the calculation of available foreign tax credits in the year in which the taxpayer recognizes the relevant income for U.S. tax purposes. The provision is intended to apply only in certain potentially abusive situations and does not target normal timing differences between U.S. and foreign tax accounting rules. These provisions would apply to foreign taxes paid or accrued after May 20, 2010.

- *Denial of foreign tax credit in "covered asset acquisitions":* The Bill would deny the foreign tax credit for the "disqualified portion" of foreign taxes following a "covered asset acquisition." A "covered asset acquisition" generally refers to a transaction in which the taxpayer receives a stepped-up tax basis and increased depreciation in the target's assets for U.S. purposes, without a corresponding increase in foreign deductions. The consequence is that the transaction would generate more foreign tax credits than necessary to eliminate double taxation of the resulting income. Under the Bill, calculation of available foreign tax credits would exclude the "disqualified portion" of foreign taxes paid, determined by reference to the difference in the tax basis of the target's assets immediately before and immediately after the acquisition. If signed into law, these provisions would be effective for covered asset acquisitions between related parties occurring after May 20, 2010, and to all other covered asset acquisitions occurring after the date of enactment.

- *Elimination of dividend "hopscotch":* If enacted, the Bill would limit the so-called "hopscotch" rule under the provisions in Subpart F of the Code addressing investments in U.S. property by controlled foreign corporations. The Subpart F regime triggers “phantom income” that is currently taxed as if the foreign subsidiary had paid a dividend directly to its U.S. parent. When this rule is used to skip over intermediate foreign subsidiaries in low-tax jurisdictions, the effective rate of foreign tax on the dividend, and the resulting foreign tax credit, is maximized. The Bill limits the foreign tax credit in these situations to the credits that would be available if the dividend were actually paid up the chain. This provision would be effective May 20, 2010.

- *Separate limitation for items re-sourced under treaties:* Effective for tax years beginning after the date of enactment, the Bill would curtail the use of tax treaties to shift U.S. income to foreign branches and disregarded entities, thereby artificially increasing foreign source income and available foreign tax credits. Under the Bill, any items of income that would be U.S. income but that are re-classified as foreign source income under an applicable tax treaty will be “limited” and no longer available to support foreign tax credits attributable to other income.

- *Allocation of interest expense among affiliates:* The Bill strengthens existing regulations that limit taxpayers’ ability to increase their net foreign source income by excluding foreign interest deductions borne by non-consolidated foreign subsidiaries. Effective for tax years beginning after the date of enactment, such foreign subsidiaries would be included in a U.S. parent’s consolidated group for purpose of calculating the amount of available foreign tax credits.

Sourcing Rule Changes:

- *Guarantees:* The treatment of guarantees under the sourcing rules has been uncertain for some time. A recent Tax Court case concluded that guarantee fees were akin to services and thus should be sourced where the service was provided; generally, this would mean that guarantee fees would be foreign source (and exempt from U.S. tax) if earned by a non-U.S. person without a U.S. trade or business. Under the Bill, however, guarantee fees would instead be treated like interest, and thus sourced by reference to the payor, without regard to where the guarantee is made; accordingly, cross-border guarantee fees would potentially be subject to U.S. withholding taxes if paid by a U.S. person, even if received by an offshore guarantor with no other connection to the United States. These provisions are effective with respect to guarantees issued after the date of enactment.

- Under current law, dividends and interest paid by a U.S. company that derives at least 80% of its income over a three-year testing period from the active conduct of a foreign trade or business are treated as foreign source. Subject to certain transition rules for existing 80/20 corporations, the Bill would eliminate the 80/20 rule for taxable years beginning after December 31, 2010.

Redemptions by Foreign Subsidiaries: If a foreign multinational indirectly owns a foreign subsidiary through a U.S. corporation, the multinational can bypass the U.S. taxes that would otherwise apply to repatriations of the foreign subsidiary’s earnings by selling a portion of its stock in the U.S. corporation to that foreign subsidiary. In addition, this transaction would decrease the foreign subsidiary’s earnings and profits, which would reduce the amount of a future distribution that would be taxed as a dividend under U.S. tax principles. The Bill would target this structure by disallowing any reduction in the foreign subsidiary’s earnings and profits with respect to amounts paid for the U.S. corporation’s stock, which would preserve taxable dividend status for future distributions. This provision would be effective as of May 20, 2010.

5. Benefits Provisions.

- *New Disclosure Obligations:* Effective for plan years beginning after December 31, 2011, the Bill would impose significant new disclosure obligations on plan administrators and providers of services to “401(k)” and other individual-account plans subject to ERISA, including many 403(b) plans. The new rules would require service providers to give plan administrators detailed information regarding various aspects of their compensation and the relative costs of available investment alternatives. Plan administrators, similarly, would be required to give plan participants detailed information about investment alternatives. Noncompliance could result in significant excise taxes under the Code, among other sanctions. The proposed rules grow out of a comprehensive look by Congress at the existing statutory and regulatory regime governing investments under so-called "participant-directed" plans.

- *Extension of COBRA Subsidy:* The legislation would extend the previously established COBRA subsidy program by extending to December 31, 2010 the period during which an involuntary termination of employment triggers eligibility for the 65% premium subsidy. The extension would be retroactive to June 1, 2010. In the case of an individual who was involuntarily terminated on or after June 1, 2010 and prior to the enactment date, the same rules that have applied to extended COBRA election periods since the inception of the subsidy program in March 2009 will continue to apply.
- *Pension Funding Relief:* The Bill contains pension funding relief provisions that would have the general effect of relieving plans temporarily of some required funding obligations (subject to restrictions where the plan sponsor uses assets for "excessive" compensation or certain dividends and redemptions), easing restrictions on the use of credit balances, and extending other previously enacted funding-related relief.

6. Extenders.

The Bill would extend, generally for one year, certain tax incentives that expired as of December 31, 2009. These include:

- a reinstatement for the 2010 tax year of the research credit;
- the active financing exception and the favorable "look-through" rules for related party payments under Subpart F of the Code;
- the look-through rules for interest-related dividends, short-term capital gain dividends, and other special rules applicable to foreign shareholders that invest in regulated investment companies, including with respect to estate taxes; and
- the qualified investment entity rules for regulated investment companies under the Foreign Investment in Real Property Tax Act, or "FIRPTA."

Contact Ropes & Gray

The foregoing is intended only as a summary of certain provisions expected to be most important to our clients. Click here to see the entire Bill.

For more information on the Bill or if you have other related questions, please contact any member of the Tax & Benefits Department of Ropes & Gray.

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