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# KPMG report: Senator Wyden's carried interest bill; preliminary observations

Senator Ron Wyden (D-OR), ranking member of the Senate Finance Committee, introduced legislation addressing the taxation of carried interests. The bill is entitled the "Ending the Carried Interest Loophole Act" and in the following discussion will be identified as the "Wyden Bill."

Following are some preliminary observations regarding the Wyden Bill. Read text and documents relating to the Wyden Bill in ***TaxNewsFlash***

## In general

The Wyden Bill proposes a different regime for taxing carried interest than prior carried interest proposals.

The Wyden Bill, in some ways, incorporates concepts of the carried interest legislation introduced by former Ways and Means Chairman Camp in 2014 (the "2014 Bill"). Conceptually, the 2014 Bill would have treated a holder of an "applicable partnership interest" as incurring a loan in an amount equal to the capital necessary to support its highest share of profits. The holder of an applicable partnership interest effectively would recognize imputed "interest" on this interest-free loan through the recharacterization of future partnership income allocations. Specifically, an imputed "interest" rate would be applied to that deemed invested capital amount to create a "recharacterization account balance." The applicable partnership interest holder then would recognize income items, including capital gain, allocated in the future by the partnership as ordinary income until such allocations were equal to the recharacterization account balance.

The Wyden Bill follows a deemed loan model similar to that included in the 2014 Bill, but instead of recharacterizing future income to ordinary as such income is allocated by the partnership, the Wyden Bill would tax the partner currently on the imputed interest amount as ordinary income. The Wyden Bill provides that the partner would receive an equivalent capital loss. Presumably, the thought may be that the capital loss would be available to offset capital gain allocated in the future, so that the ordinary income inclusion essentially would function as an acceleration of future capital gain. Note, however,

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that if the partnership never produces capital gain and the partner otherwise does not recognize capital gain, the ordinary income inclusion would function purely as a phantom income inclusion.

## Detailed description

### Receipt of a partnership for services

Under the Wyden Bill, if a partner receives a partnership interest in connection with the performance of services, the partner would be treated under section 83 as receiving property with a fair market value equal to the "liquidation value" of the partnership interest. The partner would be deemed to make a section 83(b) election and would have to affirmatively elect otherwise if it wished to avoid the impact of section 83(b) treatment. The partner's "capital account" for purposes of subchapter K would equal the amount of the income inclusion. For purposes of this provision, the term partnership interest would be defined broadly to include a number of other financial instruments or contracts that could mimic the value of a partnership interest when the interest would qualify as an "applicable partnership interest" subject to the rules described below.

### Who would be subject to the Wyden Bill?

The Wyden Bill provisions would apply to the holder of an "applicable partnership interest." An applicable partnership interest would be defined in a manner that is similar to current Code section 1061, although a "specified asset" would include any partnership interest under the Wyden Bill (rather than widely held or publicly traded partnerships and partnerships that hold other specified assets, as covered by current section 1061).

The Wyden Bill also would include as an applicable partnership interest any partnership interest held by a taxpayer who received an "applicable loan" (described below). Although probably a rare circumstance, the applicable loan provision has the potential to subject taxpayers to carried interest taxation under the Wyden Bill even though such taxpayers may have provided no services to the partnership.

In addition, for these purposes, the Wyden Bill includes as a partnership interest an applicable financial instrument or contract when the value of such an instrument or contract is determined by reference to the value of the partnership. This expansion of the applicable partnership interest definition is similar to the "disqualified interests" concept that is part of the "Carried Interest Fairness Act of 2019" as introduced by Representative Pascrell and Senator Baldwin (the "Pascrell and Baldwin Bill").

### Inclusion of "deemed compensation amount"

Under the Wyden Bill, the holder of an applicable partnership interest would be required to include in gross income annually an amount of ordinary income equal to the "deemed compensation amount." The "deemed compensation amount" would be calculated as: (1) the "specified rate" for the calendar year in which the tax year begins (i.e, the par yield for 5-year High Quality Market corporate bonds (2.94% in April) plus 9%), multiplied by (2) the excess of (a) a percentage equal to the partner's highest percentage of profit that could be allocated assuming all performance targets are met multiplied by the aggregate invested capital of all partners, over (b) the weighted average invested capital for the applicable partnership interest.

This provision effectively would treat the holder of the applicable partnership interest as having borrowed an amount equal to the capital that supports its highest possible share of profits (e.g., 20% profit for carried interest would equate to 20% of the partnership's invested capital) reduced by the partner's invested capital. The specified rate essentially would impute ordinary income like section 7872 would impute interest on a compensation-related loan, although the Wyden Bill imposes a much higher rate.

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It is notable that, although the bill text references a partner's "highest percentage of profits," the Detailed Summary accompanying the Wyden Bill indicates that it is not the intent of the bill that "catch-up" allocations should be taken into account in determining this "highest share," apparently signaling that regulations should be issued for carry out this intent.

"Invested capital" generally would be calculated as: (1) the sum of (a) the money and net fair market value of property contributed by the partner, plus (b) the partner's distributive share of income and gain (excluding revaluation gain), over (2) the sum of (a) the money and net fair market value of property distributed to the partner, plus (b) the partner's distributive share of loss and deductions (excluding revaluation losses). Although a partner's invested capital generally would be credited with contributions of cash, to the extent that cash is funded through an "applicable loan," such invested capital credit would be disregarded. An "applicable loan" would be a loan issued directly or indirectly by the partnership, another partner, or a person related to the partnership or such other partner, but would not include a loan that is fully recourse to the borrower so long as the interest rate charged on the loan is at least equal to the "specified rate" (described above). The Pascrell and Baldwin Bill also contains rules limiting qualified capital credit for certain borrowing arrangements, although the model for taxing carried interest under that bill is very different from the Wyden Bill.

**"Offsetting" capital loss**

To the extent that a partner includes the deemed compensation amount as ordinary income, the partner would report an equivalent capital loss in the same tax year. The intent seems to be to treat the deemed compensation amount as an accelerated recharacterization of future capital gain—that is, when capital gain is recognized and allocated by the partnership in the future, the previously reported capital loss would be available to offset such gain (to the extent not used to offset other capital gain of the taxpayer). So there would be only one "net" inclusion of income.

Note, however, that this model assumes that capital gain would be recognized in the future. The result appears perverse in that the holder of an applicable partnership interest in a partnership that performs poorly would be treated worse (i.e., phantom income assuming that the partner does not have other capital gain) than one in a partnership that performs well (i.e., accelerated recharacterization of future capital gain to current ordinary income, but no phantom income over the life of the partnership).

**Acceleration upon disposition of an applicable partnership interest**

The Wyden Bill appears to accelerate future deemed compensation amounts if a partner disposes of an applicable partnership interest within the 10-year period beginning on the later of (1) the date the taxpayer acquired the applicable partnership interest, or (2) the last date on which the partnership was eligible to revalue its assets under the section 704(b) regulations (the "applicable period"). According to the detailed summary of the Wyden Bill:

> *If a taxpayer who holds an applicable partnership interest sells or disposes of such interest during a taxable year in the applicable period, the deemed compensation amount to be included for such tax year is equal to the amount determined as if no such sale or disposition had occurred plus the product of such amount and the number of taxable years beginning after the date of the sale or disposition and before the last day of the applicable period.*

The proposed statute is drafted in a confusing manner, and it is not clear that it produces the described result. Nonetheless, it is clear that acceleration of a deferred compensation amount is intended.

**Reporting**

The Wyden Bill imposes on the partnership responsibility for reporting a partner's deemed compensation amount. This reporting also is required for any entity that receives a report of a deemed compensation amount.

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## Proposed effective date

The Wyden Bill is proposed to be effective for taxable years of a taxpayer beginning after the date of enactment with or within which ends the tax year of a partnership which begins after such date.

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