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The Wyden Bill: A New Approach to Taxing Carried Interest

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Senator Ron Wyden, the ranking minority member on the Senate Finance Committee, introduced a bill that represents a dramatic departure from the previously proposed approaches for the taxation of carried interest.

Background

Section 1061 of Public Law 115-97 (commonly called the “Tax Cuts and Jobs Act of 2017”) addressed the taxation of carried interest by extending to three years the holding period required for investment fund sponsors to obtain favorable capital gains rates on allocated gain with respect to capital assets. It appears, however, that some members of Congress do not consider the carried interest issue to be settled.

On March 13, 2019, Senator Tammy Baldwin (D-WI) and Representative Bill Pascrell (D-NJ) introduced identical bills in the Senate and House entitled the “Carried Interest Fairness Act of 2019.”¹ These bills are virtually identical to the Carried Interest Fairness Act of 2015 introduced by Representative Sander

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¹ S. 781, 116th Cong.; H.R. 1735, 116th Cong.

Levin (D-MI)² and Senator Baldwin in a previous Congress.³ Until this May, the 2015 bill represented the latest in the evolution of the general Democratic approach to taxing carried interest that was first introduced by then-Chairman of the House Ways and Means Committee Levin in 2007.⁴ At a very high level, the approach entailed taxing all amounts allocated to fund managers as ordinary income, except to the extent that those managers contributed “qualified capital” entitling the managers to allocations that could be benchmarked to allocations received by other limited partners who contributed capital and provided no services to the relevant investment fund.⁵

More recently, on May 23, 2019, Senator Ron Wyden (D-OR), the ranking minority member on the Senate Finance Committee, introduced the “Ending the Carried Interest Loophole Act” (the “Wyden Bill”).⁶ The Wyden Bill represents a dramatic departure from the approaches previously proposed by Democratic members of Congress.

A New Regime with Elements of a Prior Republican Proposal

The Wyden Bill, in some ways, incorporates concepts of the carried interest provision proposed in the Tax Reform Act of 2014 introduced by former Ways and Means Chairman Dave Camp (R-MI) (the “2014 Proposal”) as part of a larger tax reform bill.⁷ Conceptually, the 2014 Proposal 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.⁸ 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 the allocations were equal to the recharacterization account balance.

The Wyden Bill follows a deemed loan model similar to that in the 2014 Proposal, but instead of recharacterizing future income to ordinary as the income is allocated by the partnership, the Wyden Bill would tax the partner *currently* on the imputed interest amount as ordinary income.⁹ The Wyden Bill

² In 2015, Rep. Levin was the ranking Democrat on the House Ways and Means Committee.

³ H.R. 2889, 114th Cong. (introduced June 25, 2015); S. 1686, 114th Cong. (introduced June 25, 2015). For a detailed discussion of the Carried Interest Fairness Act of 2015 and prior versions of legislation introduced by Representative Levin, see James B. Sowell, *Levin Takes Another Shot at Carried Interest*, 148 Tax Notes 685 (Aug. 10, 2015); James B. Sowell, *Carried Interest: Line Drawing and Fairness (or Lack Thereof)*, 141 Tax Notes 617, 620-621 (Nov. 11, 2013) (Part 1); James B. Sowell, *Carried Interest: Line Drawing and Fairness (or Lack Thereof)*, 141 Tax Notes 721 (Nov. 18, 2013) (Part 2); and James B. Sowell, *Carried Interest: Line Drawing and Fairness (or Lack Thereof)*, 141 Tax Notes 857 (Nov. 25, 2013) (Part 3).

⁴ H.R. 2834, 110th Cong. (introduced June 22, 2007).

⁵ Carried Interest Fairness Act of 2019, § 710.

⁶ S. 1639, 116th Cong. [hereinafter Wyden Bill].

⁷ H.R. 1, 113th Cong., § 3621 (introduced Dec. 10, 2014).

⁸ For a detailed discussion of the carried interest provision contained in the 2014 Proposal, see James B. Sowell, *Camp’s Plan for Carried Interest: One Step Forward, One Step Back*, 142 Tax Notes 1475 (Mar. 31, 2014).

⁹ See *infra* notes 21 - 26 and accompanying text.

would provide for the partner to receive an equivalent capital loss.¹⁰ Presumably, the thought is 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, 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 Interest 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.¹¹ 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.¹² The partner’s “capital account” for purposes of subchapter K would equal the amount of the income inclusion.¹³ 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 where the interest would qualify as an “applicable partnership interest” subject to the rules described below.¹⁴

Who Would Be Subject to the Wyden Bill?

The Wyden Bill provisions would apply to the holder of an “applicable partnership interest.”¹⁵ An applicable partnership interest is defined in a manner that is similar to current 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).¹⁶

The Wyden Bill also would include as an applicable partnership interest any partnership interest held by a taxpayer who received an “applicable loan” (described in the section below).¹⁷ 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 those taxpayers may have provided no services to the partnership.¹⁸

¹⁰ See *infra* notes 28 - 29 and accompanying text.

¹¹ Wyden Bill, § 83(c)(4)(A)(i).

¹² Wyden Bill, § 83(c)(4)(A)(ii).

¹³ Wyden Bill, § 83(c)(4)(B).

¹⁴ Wyden Bill, § 83(c)(4)(D).

¹⁵ Wyden Bill, § 1299(a).

¹⁶ Wyden Bill, § 1299(b).

¹⁷ Wyden Bill, § 1299(b)(1)(B).

¹⁸ For example, if a passive limited partner received in an unrelated transaction a nonrecourse loan from another partner in the partnership, that passive limited partner’s interest in the partnership apparently would be treated as an applicable 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.¹⁹ 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 2019.²⁰

Inclusion of “Deemed Compensation Amount”

Under the Wyden Bill, the holder of an applicable partnership interest is required to include in gross income annually an amount of ordinary income equal to the “deemed compensation amount.”²¹ The “deemed compensation amount” is 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 (2.55% in June) 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.²²

This provision effectively treats 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 imputes ordinary income like section 7872 would impute interest on compensation-related loan, although the Wyden Bill imposes a much higher rate.

It is notable that although the statute 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 to carry out this intent.²³

“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

interest. The limited partner could accrue a deemed compensation amount if the partner were entitled to an allocation of income in excess of his or her percentage share of capital.

¹⁹ Wyden Bill, § 1299(b)(2).

²⁰ Carried Interest Fairness Act of 2019, § 710(e).

²¹ Wyden Bill, § 1299(a)(1).

²² Wyden Bill, § 1299(c)(1). For example, assume a situation where the total weighted average invested capital for the fund for the tax year is equal to \$500 million and the general partner’s share of the weighted average invested capital is \$5 million. The general partner is entitled to a one-percent share of profits as a result of its invested capital and also is entitled to a 20% carried interest after the limited partners have received a stated preferred return. Under these facts, the general partner’s deemed compensation amount for the year would be \$11.55 million (11.55% specified rate x ((21% applicable percentage x \$500 million Invested Capital of all partners) - \$5 million Invested Capital of general partner)).

²³ *Ending the Carried Interest Loophole Act – Detailed Summary*, at 6, fn. 8 [hereinafter *Detailed Summary*].

revaluation losses).²⁴ 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," the invested capital credit would be disregarded.²⁵ 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, but does 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 three paragraphs above.²⁶ The Carried Interest Fairness Act of 2019 also contains rules limiting qualified capital credit for certain borrowing arrangements,²⁷ although the model for taxing carried interest under that bill is very different from the Wyden Bill.

An "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.²⁸ 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 that 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 will be recognized in the future. The result seems 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).²⁹

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").³⁰ 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

²⁴ Wyden Bill, § 1299(c)(4)(A).

²⁵ Wyden Bill, § 1299(c)(4)(B).

²⁶ Wyden Bill, § 1299(b)(4).

²⁷ Carried Interest Fairness Act of 2019, § 710(d)(8).

²⁸ Wyden Bill, § 1299(a)(2).

²⁹ Query the impact of such a provision on the decision process of an individual looking to start raising investment funds. The financial risk no longer would be limited to the individual's capital invested in the business, but also would include the taxes paid on phantom ordinary income that would never be recouped if the individual never earns capital gain income.

³⁰ Wyden Bill, § 1299(c)(5).

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.³¹

The proposed statutory language is confusing as drafted, 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 would impose on the partnership responsibility for reporting a partner's deemed compensation amount.³² This reporting also would be required for any entity that receives a report of a deemed compensation amount.³³

Proposed Effective Date

The Wyden Bill is proposed to be effective for tax years of a taxpayer beginning after the date of enactment with or within which ends the tax year of a partnership that begins after such date.³⁴

Conclusion

The prospects for passage of the Wyden Bill are uncertain. Critics of the proposal have focused on the potential for phantom income—a possible result that might be hard for the drafters to defend. More generally, in the current Congress, Senate passage of further carried interest legislation might be difficult, plus there are not likely to be many vehicles for tax legislation. Nonetheless, if any tax legislation does move forward in what remains of this Congress, there is a possibility that some sort of carried interest provision could be included as a revenue raiser in the horse-trading associated with putting together such a bill.

Moreover, even if further changes to the treatment of carried interest do not advance in the current Congress, they might stand a better chance of becoming law in the future—with the Wyden Bill potentially providing the general framework.

Accordingly, those who are interested in the treatment of carried interest may want to understand and monitor the status of the Wyden Bill.

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³¹ *Detailed Summary*, at 6-7.

³² Wyden Bill, § 1299(d).

³³ *Id.*

³⁴ Wyden Bill, § 3(c).

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