Proposals to Tax Carried Interests

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Rationale for CG differential

- Spur saving, investment and growth
- Hybrid consumption tax
- Reduces lock-in effects
- Double tax – already paid tax on income saved
- Double tax on corporate earnings – form of integration
- Reduces bunching of income
- Reduces inflation effects
- Similar treatment as other countries
Arguments Against Differential

Gains already deferred – realization principle

Regressivity

Warren Buffett – Buffett Tax

Economic inefficiency – Shift into favored forms of investment

No evidence that it actually increases savings/investment

- Burman: “From 1954 to 1996, the correlation between the percentage change in real GDP and the maximum tax rate on capital gains is essentially zero (-.01).”

Encourages sheltering, conversion and arbitrage.

Adds complexity to enforcement & administration
Typical Fund Structure

- Fund typically pays a fixed return on invested capital (8%-10%), and thereafter GP starts to share in profits based upon its contribution of services.
- The GP’s share of profits based upon services (i.e., the portion it receives in addition to its invested capital) typically is 20% and is referred to as a “carried interest”.
- The GP also receives a management fee that is intended at least to cover the GP’s operating expenses.
- Because the carried interest represents a share of partnership profits, under the partnership rules, the income allocated to the GP reflects the character of the income earned by the partnership.
- In an investment partnership, this income often will reflect capital gain taxed at a 20% rate (as opposed to 39.6% maximum rate applicable to ordinary income) – Management fee is ordinary income.
Typical Treatment of Equity Issued for Services

Under section 83, the value of an equity interest received in exchange for services typically will be taxed at ordinary income rates

Ex., Receive stock of Facebook pre-IPO; value at receipt is $1 million and that measures ordinary income inclusion (assuming stock is vested); post-IPO value climbs to $100 million and sell at that price; Capital gain = $99 million

Partnership tax rules (Rev. Procs. 93-27 and 2001-43) provide that an equity interest in future profits and appreciation only will, in most situations, be presumed to have a $0 value upon receipt, so that there is no ordinary income inclusion even if a third-party would, in fact, pay something for the interest

Common stock in a corporation generally represents a pro rata share of the equity interest in a business enterprise (ignoring preferred shares), so there often will be a reasonable benchmark for valuing the stock

A carried interest generally represents a different interest than any other capital investor in a partnership and thus can be harder to value – the value often is very speculative

There are certain stock arrangements called Founder’s Stock that are somewhat similar to a carried interest

These interests can present the same valuation issues as “carried interests”
Sole proprietorship

$90x nonrecourse loan, secured by property
Annual payments of 8% interest
$90x principal repaid upon sale of property

S invests $100x cash
Develops concept and builds clientele

$200x purchase price,
S realizes $100x capital gain

Property sold after 5 years to C
Partnership, 60-40 split

A&W Partnership

$60x capital gain

$5x cash

$5x cash

$40x capital gain

$90x nonrecourse loan, secured by property

Annual payments of 8% interest

$90x loan principal repaid upon sale

S200x purchase price, A&W partnership realizes
$100x capital gain

Property sold after 5 years to C

A&W invest $100x cash

Develop concept and build clientele
Private Equity Partnership

A&W Partnership

$20x capital gain

$5x cash

$95x cash contribution

Property sold after 5 years to C

$200x purchase price. A&W partnership realizes $100x capital gain

$80 capital gain

$95x cash contribution repaid first upon sale, plus 8% hurdle rate

A&W acquire under-performing restaurant for $100 cash. Restore value and build clientele
Founders’ Shares

$10x capital gain

$5x cash for 100x shares

$5x cash for 100x shares

$10x capital gain

$90x raised in IPO, sale of 800x preferred shares

Cumulative dividends of 8%

$90x of capital repaid upon sale, plus $80 capital gain

A&W Corporation

A&W corp. acquires restaurant for $100x cash. Develops new concept and builds clientele

$200x purchase price for A&W corporation.

Corporate stock sold after 5 years to C
Implementing the Chosen Model

Who are going to subject to the rules?
Unfair to pick and choose?
Subject small unsophisticated taxpayers to complexity?
Some realize ordinary income anyway (e.g., hedge funds)
Distinguish amounts received for services from amount received from capital?
Enterprise value?
Avoidance techniques?
Loans from other partners or partnership
Potential Models for Taxing Partnership Interests Received for Services

There are four essential models that have been debated in determining how to tax service partnership interests

The “stock” model, where the recipient of the partnership interest is taxed at ordinary income rates on the value of the interest at the time of receipt or vesting

Continue assumption that a pure profits interest (i.e., shares only in future income and appreciation) received for services is not taxed upon receipt or vesting, but all income allocable with respect to the partnership interest will be taxed at ordinary income rates

Continue assumption that a pure profits interest (i.e., shares only in future income and appreciation) received for services is not taxed upon receipt or vesting, but all income allocable with respect to the partnership interest will be taxed at a blended rate between ordinary income and capital gain rates

The “imputed loan” model, where the GP is treated as borrowing an amount of capital equal to his or her “carried interest” share of profit, with interest being imputed on that loan that is taxed at ordinary income rates – interest may be imputed currently or may establish an “account” that measures allocable partnership income that must be taxed at ordinary income rates

- Ex., Partnership invested capital is $100 million; GP has 20% carried interest; GP is treated as borrowing $20 million, and interest is imputed on that loan
Carried Interest - Proposed Legislation

Competing versions of carried interest legislation

Levin (a Democrat) Proposal

— All income allocable to designated service partners is taxed at ordinary income rates except to the extent income is attributable to qualified capital interest

— Broad anti-abuse rules including rules relating to “disqualified interests”

— See J. Sowell, Carried Interest: Line Drawing and Fairness (or Lack Thereof), 141 Tax Notes 617 (Nov. 11, 2013) (Part 1); 141 Tax Notes 721 (Nov. 18, 2013) (Part 2); and 141 Tax Notes 857 (Nov. 25, 2013) (Part 3).


Camp (a Republican) Proposal

— In effect, an interest charge is imputed to amount of capital that supports carried interest (e.g., 20% of capital if carried interest is 20%), and allocated income is ordinary income until income exceeds imputed interest amount

  - At applicable AFR, interest charge is approximately 13% (calculated as the long-term AFR + 10 percent)

— No provision apparently permitting a return on capital at capital gain rates until allocations exceed deemed interest charge

— According to the House Ways and Means Staff summary, real estate is intended to be excluded, although parameters of intended exclusion are unclear

Carried Interest – Example Under Levin Version

Partnership contributed capital is $1.1 billion. Sponsor contributed $100 million as an LP. Sponsor serves as the GP through the same entity. Waterfall provides for return of capital, plus 8% preferred return, and then, with respect to each LP, 80-20 between that LP and the GP. Partnership owns two assets, each accounting for $550 million of contributed capital and adjusted basis.

After one year, Partnership sells one asset for $700 million ($150 million gain).

Income allocated to LPs = $137.6M ($88M (pref) + $49.6 (80% x $62M)).

$12.5M of this amount is allocated to the Sponsor as an LP.

$12.4M is allocated to the Sponsor as GP for the carried interest (20% x $62M).

Levin Proposal
— Sponsor can benchmark return on contributed capital to other LPs who did not provide services, so $12.5M of allocated income is eligible for capital gain
— $12.4M allocated with respect to carried interest is taxed as ordinary income
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Camp Proposal

— 13% return (approx. of AFR + 10%) on $200M ($1B (LP capital contributed by parties other than Sponsor) x .20 (highest percentage share of profit other than with respect to contributed capital)) is $26M, which sets the cap on ordinary income allocable to the Sponsor

— $24.9M allocable to Sponsor (carry and return on capital) is less than $26M cap, so all $24.9M is taxable as ordinary income.
Enterprise Value Generally

Enterprise value refers to the intangible value of an investment sponsor that arises in connection with the business operations of the sponsor.

While a fund sponsor’s value may relate, in part, to the value of traditional carried interests held in its investment funds, a fund sponsor often also will have significant value attributable to its name, reputation, workforce in place, business methods, investor lists, etc.

The taxation of gain attributable to enterprise value is different from the gain generated with respect to carried interests, and strong arguments can be made that enterprise value gain should not be taxed at ordinary income rates.
Enterprise Value under the 2015 Levin Bill

The 2015 Levin Bill addressed the “enterprise value” issue by limiting the interests covered by the legislation to interests in an “investment partnership.”

Under the 2015 Levin Bill, the term “investment partnership” means any partnership if, at the end of any two consecutive calendar quarters ending after the date of enactment:

— Substantially all of the assets of the partnership are specified assets (determined without regard to any section 197 intangible), and

— Less than 75 percent of the capital of the partnership is attributable to qualified capital interests which (in the hands of the owners of such interests) constitute property held in connection with a trade or business.

Due to the high concentration in many sponsor entities of ownership by partners who are active in the business, along with the potential for ownership of material assets that are not specified assets, in some situations, the sponsor entity would not be an “investment partnership” so that gain recognized upon the sale of an interest in the sponsor entity would not be treated recognized in connection with the sale of an ISPI.
Enterprise Value under the 2015 Levin Bill

Under the 2015 Levin Bill, an ISPI would be treated as a “hot asset” under section 751 so that, upon sale of an interest in a sponsor entity that holds ISPIs in sponsored funds, the gain recognized that is attributable to such ISPIs would be recharacterized as ordinary income.

By incorporating the “hot asset” rules under section 751, the 2015 Levin Bill continues to tax the gain attributable to ISPIs at ordinary income rates, while leaving gain attributable to other intangible assets held by the sponsor entity to be taxed at capital gain rates.
Enterprise Value under the 2014 Camp Proposal

The 2014 Camp Proposal contains no provisions specifically addressing the enterprise value issue.

Under the 2014 Camp Proposal, it is not clear whether an interest in the sponsor entity is an “applicable partnership interest” or how one should calculate the “recharacterization account balance” with respect to an interest in such an entity (i.e., do “recharacterization account balances” related to lower-tier partnerships tier up?).

The 2014 Camp Proposal does not incorporate the “hot asset” rules under section 751, so it is not clear that, upon a sale of an interest in the sponsor entity, gain attributable to “applicable partnership interests” held by the sponsor entity would be recharacterized as ordinary income.

It is possible that the enterprise value issue could be addressed under regulations authorized to address the application of the 2014 Camp Proposal “in cases of tiered structures of entities.”
Prospects Looking Ahead

There has been discussion as to whether the Obama Administration could alter the taxation of carried interest without legislation.

See D. Moroses, Congressional Action Required on Carried Interest, 2016 Tax Notes Today 95-6 (May 17, 2016).

Political scenarios and legislative prospects.
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