NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON PROPOSED CARRIED INTEREST AND FEE DEFERRAL LEGISLATION

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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED CARRIED INTEREST
AND FEE DEFERRAL LEGISLATION

This report (the "Report") of the New York State Bar Association Tax Section provides technical comments on two legislative proposals:*

- Section 710 of H.R. 6275, which would tax the service element of the "carried interest" in a typical investment partnership as ordinary compensation income; and
- Section 457A of H.R. 6049 and S. 3335, which would prohibit most deferrals of compensation by U.S. managers who provide services to certain "tax-indifferent" partnerships or foreign corporations.

I. Introduction

A. Carried Interest Bill

Under current law, the grant of a profits interest for services is not a taxable event. Nevertheless, the service provider generally qualifies as a partner of the issuing partnership on the date of grant. As such, the service provider may report his or her allocable share of the future income of the partnership in accordance with its character, as determined at the partnership level. It is on this basis that a typical fund manager of an

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investment partnership avoids immediate tax upon the grant of a "carried interest" for services and bears tax on its allocable share of future partnership income at rates that may be as low as 15%.

At the end of 2007, the House proposed legislation that, if enacted, would have taxed the service element of a carried interest as ordinary income in virtually every private equity fund, venture capital fund, LBO fund, hedge fund and real estate fund in the market.[1] Following the threat of a Bush Administration veto, the House dropped the carried interest proposal from the bill. On June 25, 2008, however, the House approved a substantially identical proposal (the "Bill").[2] At this stage, it is uncertain whether this proposal will experience the same fate as its predecessor. As of the date of this Report, however, current law in this area remains unchanged: neither the receipt of a profits interest nor the subsequent allocation of income generates taxable service income to the holder.[3] This special treatment is unique to partnerships. In the non-partnership context, although the service element of the transaction also closes on the date of grant, § 83 usually taxes the service provider at that time on the full fair market value of the property.[4]

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[1] H.R. 3996, Temporary Tax Relief Act of 2007. Congressman Rangel introduced the bill on Oct. 30, 2007, which was passed by the House on Nov. 9, 2007.

[2] H.R. 6275, The Alternative Minimum Tax Relief Act of 2008. Congressman Rangel introduced the bill on June 17, 2008, which was passed by the House on June 25, 2008.

[3] Under certain conditions, service income at the partnership level will retain its character as such under § 702 of the Code. See IRC §§ 702(a)(8); 1402(a)(1).

[4] Unless the context clearly indicates otherwise, all "Section" references are to the Bill. All "§" references are to the Internal Revenue Code of 1986, as amended (the "Code") or Regulations.

The Bush Administration has threatened to veto the Bill or any other bill that includes a similar proposal.[5] Even if the House drops this proposal from the Bill, however, it is likely that Congress will revisit current law taxation of the carried interest in a future session.[6] Should Congress ever do so, it will probably begin with the basic framework of the Bill, at least as a starting point.

B. Anti-Fee Deferral Bill

Under current law, a cash method service provider must report income upon actual or constructive receipt.[7] The cash method of accounting does not depend upon whether the service provider's right to the income is fixed and determinable before the date of payment. A cash basis service provider who charges a fixed percentage of the profits of an investment fund as a fee for services may therefore defer the fee beyond the taxable year of service if the deferral meets certain conditions (including, as applicable, the conditions of § 409A). The timing of the compensatory event to the service provider does not depend upon whether the investment fund or its investors will otherwise derive an offsetting tax benefit from the compensation deduction.

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[5] Chuck O'Toole, "White House Promises Veto of House AMT Bill", Highlights & Documents (June 25, 2008).

[6] See, e.g., "Carried Interest Expert Says Legislative Response 'Still in Play'", 2008 Tax Day (February 1, 2008); Meg Shreve, "Finance Still Looking Into Deferred Comp, Carried Interests," Tax Notes, March 17, 2008, at 1199 (counsel to Senate Finance Committee says that private equity taxation could be "front and center" in future tax reform proposals); "Bowers Says Officials Weighing Safe Harbor" BNA Daily Tax Report (June 2, 2008) (indicating that proposed legislation "is likely to resurface in the next Congress"); Crystal Tandon, "Treasury Not Subject to White House Guidance Order, Solomon Confirms," Tax Notes, June 9, 2008 ("on the legislative side, Solomon warned practitioners that given the 'pay as you go' budget rules favored by Democrats, revenue raising proposals like taxing carried interest and offshore deferred compensation could continue to receive consideration ... all of the recent revenue-raising proposals are in play").

[7] See IRC § 451; Regs. § 1.451-1(a).

In 2007, the House proposed legislation that, if enacted, would have imposed substantial limitations on the ability of a service provider to defer compensation from certain partnerships and foreign corporations.[8] A similar proposal appeared in H.R. 3996, which is the same bill that had proposed to tax the service element of a carried interest in a typical investment partnership.[9] Although the House dropped both of these proposals from that bill, it re-proposed the anti-fee deferral bill on May 21, 2008.[10] Finally, on July 25, 2008, the Senate Finance Committee approved a substantially identical proposal.[11] If enacted, the anti-fee deferral bill is likely to prohibit fee deferrals by U.S.-based managers of foreign funds that derive no significant tax benefit from the compensation deduction. These taxpayers are the primary targets of the bill.

C. Scope of Report

We express no view on the policy question of whether the Code should tax the service element of a profits interest issued by an investment partnership as ordinary income. Nor do we express any view on the policy question of whether the Code should prohibit deferrals of compensation by taxpayers who provide services on behalf of a "tax indifferent" employer. For purposes of this Report, we have assumed that Congress will adopt some form of both of these proposals. This Report therefore describes the technical issues that these proposals will present, together with possible solutions.

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[8] H.R. 4351, AMT Relief Act of 2007.

[9] H.R. 3996, Temporary Tax Relief Act of 2007.

[10] H.R. 6049, Renewable Energy and Job Creation Act of 2008.

[11] S. 3335, The Jobs, Energy, Families, and Disaster Relief Act of 2008.

II. Summary of Recommendations

For the reasons described more fully in Section V. of this Report, our principal recommendations are as follows:

- Reconciliation with § 83. Congress should amend § 83 either to compel or permit the use of "liquidation value" as the sole appraisal methodology for valuing the initial grant of an investment services partnership interest (an "ISPI"). If the ISPI in question is a "capital interest" rather than a "profits interest" within the meaning of Revenue Procedure 93-27, the grantee should receive "invested capital" credit under the Bill in an amount equal to the income reportable as compensation upon grant or vesting. If Congress declines to amend § 83 as described above, it should nevertheless cap any invested capital credit to the service provider under the Bill at the liquidation value of the ISPI upon grant or vesting.

- Invested Capital. Congress should modify the definition of "invested capital" to reflect not only the cash and the fair market value of any property contributed to a partnership, but amounts credited (or debited) to the book capital account of the service provider to reflect (i) recognized taxable income or loss; and (ii) distributions of cash or other property to the partners. In addition, future regulations should allow an adjustment to existing invested capital to reflect any unrealized gain or loss related to such invested capital when another partner contributes additional capital to the partnership or when a partnership makes a disproportionate distribution to a partner, in each case as may be necessary or appropriate for testing the "reasonableness" of any future allocations to invested capital.[12]

- Allocations of Income to Invested Capital. Congress should modify the manner in which the Bill apportions the service provider's income between invested capital and services in two respects:

[12] See sections V.A.1(g) and V.A.2(b) of this Report. In this regard, it will be necessary to isolate the portion of the unrealized gain or loss "related to" invested capital, which is not a simple undertaking. The book capital account of the service provider following a revaluation may reflect changes in value attributable to the portion of the ISPI acquired for invested capital and the portion of the ISPI acquired for services.

- first, it should eliminate the "cliff effect" associated with "unreasonable" allocations of income to invested capital, treating only the excess portion of the allocation as ordinary income for services; and

- second, it should either eliminate or temper the severity of the "per se" unreasonable rule, which caps the service provider's maximum permissible return on invested capital at the lowest rate of return to any non-service partner. This presumption places the service provider in an inferior tax position vis-à-vis a similarly-situated non-service partner who contributes a like amount of invested capital, and is therefore a poor proxy for establishing the portion of the service provider's income that represents taxable compensation for services.

- Exclude Operating Partnerships. Congress should revise the language of the Bill to ensure that it captures the intended targets of the legislation, but excludes operating partnerships and other unintended targets. One possible mechanism for doing so is to limit the application of the Bill to partnerships with "specified assets" that represent a substantial percentage of the partnership's total assets. To deter efforts to circumvent the Bill in response to a purely "asset-based" test, any minimum threshold of this kind should be subject to an overriding anti-abuse rule that would permit Treasury in appropriate cases to either aggregate assets of multiple related partnerships or disaggregate assets within a single partnership. Any asset-based test should also grant relief to a partnership that is not a "financial buyer" of the type described in the legislative history, but rather operates a strategic business, either in whole or in part, through one or more corporate subsidiaries. For example, an asset-based test might permit certain partnerships to "look through" the stock of any majority-owned subsidiary to treat the partnership as owning a pro rata share of the assets of such subsidiary;

- Broad Grant of Regulatory Authority. Congress should accompany any legislative proposal in this area with a broad grant of regulatory authority. As described more fully in this Report, the implementation of the Bill is likely to raise technical issues of extraordinary complexity, including issues related to --

  - (i) the application of the Bill to tiered-partnership structures (which are pervasive in the fund sector);

- (ii) the treatment of sales and other dispositions of an ISPI, either to a related party or in an otherwise tax-free transaction;

- (iii) the collateral (and in some cases unintended) consequences of converting income of one character at the partnership level (e.g., U.S. source ECI or FDAP income) into income of another character at the partner level; and

- (iv) harmonizing the rules governing the grant of a "disqualified interest" with the treatment of such interests under current law as "property" under § 83; and

- Fee Deferrals. Rather than exempting any deferral arrangement with a treaty-eligible foreign employer, Congress should revise Proposed Section 457A to require the foreign employer to actually bear "comprehensive foreign income tax" in the treaty jurisdiction. Otherwise, service providers for foreign funds may be able to establish fee deferrals through treaty jurisdictions even though the fund itself will remain just as indifferent to the timing of the compensation deduction as a fund domiciled in a tax haven.

In addition to the foregoing recommendations, this Report also identifies a number of other technical issues (together with possible solutions) that Congress and/or the IRS may wish to address in connection with these legislative proposals, including the following:

- "Purchased" Capital. Whether a service provider should receive invested capital credit for the amount paid to another partner to acquire an ISPI; and

- Exclude Certain Partners. Whether a holder of an ISPI other than an individual, including a foreign corporation, a domestic 'C' corporation and a tax-exempt organization, should be excluded from the Bill entirely.

III. Summary of Current Law

A. Grant of a Profits Interest

Today, the tax treatment of the grant of a profits interest for services is a matter of settled law. This was not always so. In the 1970s, it was widely assumed by the tax bar

that the grant of a profits interest was not a taxable event. Although neither the IRS nor the courts had ever addressed the issue, one prominent commentator in 1971 described the state of the law as follows:

> ... it is clear that a partner who receives only an interest in future profits of the partnership as compensation for services is not required to report the receipt of his partnership interest as taxable income. The rationale is two-fold. In the first place, the present value of a right to participate in future profits is usually too conjectural to be subject to valuation. In the second place, the service partner is taxable on his distributive share of partnership income as it is realized by the partnership. If he were taxed on the present value of the right to receive his share of future partnership income, either he would be taxed twice, or the value of the right to participate in partnership income must be amortized over some period of time.[13]

As further support, others cited the apparent negative inference from Regulations § 1.721-1(b)(1), which provides that the non-recognition rule of § 721 does not apply "[t]o the extent that any of the partners gives up any part of his right to be repaid his contributions *(as distinguished from a share in partnership profits)* in favor of another partner as compensation for services".[14] The parenthetical language, they contended, evidenced an intent to extend § 721 to the grant of a profits interest for services. In Diamond v. Comm'r,[15] the IRS disavowed any such intent and both the Tax Court and Seventh Circuit agreed. Thus began two decades of litigation that failed to resolve or even clarify matters.[16]

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[13] Arthur B. Willis et al., *Partnership Taxation*, 84-85 (1971).

[14] Emphasis added.

[15] 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974).

[16] For a detailed discussion of the IRS's litigating position during the 20 year period following the Diamond case, See McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* at ¶5.02[3] (3rd ed. 1997); see also Campbell v. Comm'r, 59 T.C.M. (CCH) 236 (1990) (holding that no provision of the Code exempted the receipt of a profits interest for services from tax), rev'd on this issue,

In Revenue Procedure 93-27,[17] the IRS announced that it would no longer challenge the receipt of a profits interest for services as a tax-free transaction. Revenue Procedure 93-27 applies to a partnership interest issued to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner. It defines a "profits interest" in the negative as an interest in a partnership *other than* a "capital interest", and a "capital interest" as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership".[18]

Eight years later, the IRS announced in Revenue Procedure 2001-43[19] that it would draw no distinction between a vested profits interest and an unvested profits interest. So long as the partnership and the grantee otherwise met the conditions of Revenue Procedure 93-27, agreed to treat the grantee as a current partner, and did not claim a compensation deduction upon either grant or vesting, the IRS stated that it would not challenge either the grant or vesting of the profits interest as a tax-free transaction. The revenue procedure further clarified that the grantee of an unvested profits interest did not need to file a §83(b) election to achieve this result.

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943 F.2d 815, 823 (8th Cir. 1991) (finding that interest in question was "without fair market value at the time [of receipt] ... and should not have been included in ... income for the years in issue"); St. John v. U.S., 53 A.F.T.R.2d 84-718 (C.D. Ill. 1983) (applying a "liquidation analysis" to conclude that the profits interest had no value on receipt); Kenroy, Inc. v. Comm'r, T.C. Memo 1984-232 (same); Hale v. Comm'r, T.C. Memo 1965-274 (stating in dicta that profits interest did not constitute taxable income on receipt).

[17] 1993-2 C.B. 343.

[18] This self-imposed injunction does not apply to any profits interest related to a substantially certain and predictable stream of income from partnership assets, to a profits interest that the holder sells within two years, or to a profits interest in a "publicly-traded partnership" under § 7704(b).

[19] 2001–43 I.R.B. 2001-34.

Although these two pronouncements failed to address a number of technical issues, they have largely achieved their intended purpose of eliminating longstanding uncertainty in the law.[20]

B. Fee Deferrals

1. Taxation of the Service Provider

An accrual basis taxpayer must report gross income when all events establishing the taxpayer's right to the income and the amount thereof become determinable with reasonable accuracy.[21] Under the "all events" test, the taxpayer reports income when performance is complete, when payment is due, or when payment is made, whichever occurs first.[22] In general, therefore, an accrual basis manager of an investment fund may not defer the recognition of an incentive fee by postponing the date of receipt beyond the taxable year of service.[23]

A cash basis taxpayer must report gross income upon actual or constructive receipt.[24] A manager or other provider of services to an investment fund may therefore defer an accrued incentive fee beyond the taxable year of service if the deferral meets

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[20] On May 24, 2005, however, the IRS issued proposed regulations under §§ 704(b) and 83. See REG-105346-03, 70 Fed. Reg. 29675 (5/24/05). The proposed regulations address the tax consequences of the grant and forfeiture of a partnership interest for services. At the same time, Treasury also issued a proposed revenue procedure that, upon the effectiveness of final regulations, would obsolete Revenue Procedure 93-27 and Revenue Procedure 2001-43. See Notice 2005-43, 2005-24 I.R.B. 1221. The new rules would apply to compensatory partnership interests issued on or after the date of final regulations. Until then, Revenue Procedure 93-27 will remain in effect. Unlike Revenue Procedure 2001-43, the proposed regulations require the recipient of an unvested profits interest to make an § 83(b) election.

[21] IRC § 451(a); Regs. § 1.446-1(c)(1)(ii).

[22] Rev. Rul. 84-31, 1984-1 C.B. 127.

[23] See, e.g., FSA 200102008 (service provider must accrue management fees at year end where services were performed and the amount payable can be reasonably estimated).

[24] Regs. § 1.446-1(c)(1)(i); Regs. § 1.451-1(a)

certain conditions. First and foremost, it must be eligible to report income on the cash method of accounting. An entity organized as a partnership may report income on the cash method of accounting so long as (i) it does not have a C corporation as a partner at any time during its taxable year; and (ii) it is not a "tax shelter".[25] Second, the entity must avoid actual or constructive receipt of the incentive fee. Under the regulations, income not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time.[26] A cash basis taxpayer will be deemed to receive any property that is unconditionally and irrevocably paid to a fund or trust for the taxpayer's sole benefit.[27] Third, the fee deferral must comply with the requirements of § 409A of the Code.

§ 409A provides a statutory framework for the taxation of nonqualified deferred compensation. When it applies, §409A has three consequences: First, it requires the service provider in a non-compliant plan to report a deferral of compensation as current income when the amount deferred is no longer subject to a substantial risk of forfeiture.[28] Second, it imposes an interest charge on the tax that would have been due had the

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[25] Regs. § 1.448-1T(a)(2). Under § 448(b)(2), a C corporation does not include a "qualified personal service corporation". Moreover, a partnership with a C corporation as a partner may use the cash method of accounting if the partnership, for every prior taxable year beginning after December 31, 1985, generates no more than $5 million in average annual gross receipts for the three-year period ending with each such prior taxable year. See § 448(b)(3), (c); Regs. § 1.448-1T(f)(1), (f)(3) (Ex. 3); see also Temp. Regs. § 1.448-1T(f)(2)(ii) (gross receipts aggregated under § 448(c)(2) for all persons treated as single employer under § 52(a) or (b) or § 414(m) or (o)).

[26] See Regs. § 1.451-2(a).

[27] Sproull v. Comm'r, 16 T.C. 244 (1951) (employer's transfer in trust for benefit of taxpayer employee conferred economic or financial benefit on taxpayer taxable upon establishment of trust).

[28] H.R. Rep. No. 548, 108th Cong., 2d Sess. (2004).

compensation been includible in income in the year of initial deferral.[29] Third, the amount includible in income is subject to an additional 20% tax.[30] Although § 409A generally applies in the context of an employer of an operating business who defers the payment of wages to its employees, the reach of the statute is much broader. Under the regulations, Treasury and the IRS expanded the definition of a "service provider" to include any manager of an investment fund, whether organized as a partnership or a corporation, that provides "management services".[31] It is now clear, therefore, that § 409A applies to fee deferrals by a service provider to a hedge fund or similar entity.

2. Compensation Deduction by the Service Recipient

In general, an employer may not claim a deduction for wages or other compensation until it pays the compensation to the employee, even if the employer otherwise reports income on the accrual method of accounting.[32] In the typical case, § 404(a)(5) of the Code defers the compensation deduction until "the taxable year in which an amount attributable to the contribution is includible in the gross income of

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[29] § 409A(a)(1)(B)(i)(I).

[30] § 409A(a)(1)(B)(i)(II).

[31] Under the regulations, a "service provider" does not include an independent contractor who "provides significant services to two or more service recipients to which the service provider is not related and are not related to one another". See Regs. § 1.409A-1(f)(2)(i)(B). In the case of "management services", however, the regulations treat the service provider and the service recipient as "related" as a matter of law. See Regs. § 1.409A-1(f)(2)(iv). The regulations define "management services" to include "investment management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets ... *such as a hedge fund* ..." See Regs. § 1.409A-1(f)(2)(iv) (emphasis added).

[32] See Senate Finance Committee staff summary of S. 3335 ("Current law generally allows executives and other employees to defer paying tax on compensation until the compensation is paid. This deferral is made possible by rules that require the corporation paying the deferred compensation to defer the deduction that relates to this compensation until the compensation is paid.").

employees participating in the plan ..."[33] § 404(d) of the Code provides similar rules for payments to service providers who are not employees.

IV. Summary of Bill

A. Carried Interest Bill

Under the Bill, the service provider must report net income attributable to an ISPI as compensation for services, without regard to the character of the income at the partnership level as either ordinary or capital.[34] Accordingly, the service provider will bear tax on such income at ordinary income rates,[35] as well as self-employment tax.[36] Although the Bill also recharacterizes net losses from an ISPI as ordinary, these losses are allowed only to the extent of the prior allocations of net income to the service provider with respect to the ISPI during preceding taxable years.[37] Any net loss that the service provider cannot deduct by reason of this limitation may be carried forward and treated as a net loss sustained in the following taxable year. Suspended losses do not

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[33] See also § 404(a)(11) (potentially deferring the deduction until actual receipt by the employee); § 404(b) (extending the rules governing the timing of deductions attributable to deferred compensation plans to situations in which no "plan" exists); Temp. Regs. § 1.404(b)-1T (additional guidance regarding what constitutes a method or arrangement of deferring the receipt of compensation).

[34] Section 710(a)(1)(A).

[35] Under H.R. Rep. No. 728, effective for taxable years beginning after December 31, 2010, such income will no longer constitute "qualifying income" under § 7704(c) to a publicly-traded partnership, subject to an exception if 50% or more of the interests of a PTP are held by a REIT. See H.R. Rep. No. 728, 110th Cong., 2d Sess. at 25 (2008) ("the present law exception to corporate treatment for a publicly-traded partnership, 90% or more of whose gross income is qualifying income ... does not apply ..."); see also Section 201(e)(5) (deferred effective date for PTPs).

[36] The Bill treats such income as compensation for services "for purposes of this title". The Bill clarifies the application of employment taxes to such income by adding a new subparagraph (B) to each of § 1402(a)(13) and § 211(a)(12) of the Social Security Act.

[37] Section 710(a)(2)(A).

reduce the service provider's outside basis in the partnership during the suspension period.[38]

Upon a sale of an ISPI, the service provider must report the gain as ordinary compensation income.[39] The service provider may report any loss realized on the sale of an ISPI as ordinary as well, but only to the extent of the prior allocations of service income.[40]

If a partnership distributes appreciated property to the service provider, the Bill overrides the non-recognition rules of § 731(b). Rather than reporting the distribution as a tax-free transfer of property, therefore, the partnership must recognize gain as if it had sold the transferred property for fair market value.[41] Any gain recognized by the partnership and allocated to the service provider constitutes ordinary income from the performance of services.

None of these rules applies to income allocable to an ISPI that is attributable to a contribution of cash or other property (rather than services) by the service provider So long as the partnership makes a reasonable allocation of income to "invested capital", the service provider may report such portion in accordance with its character at the partnership level.[42] For this purpose, however, the service provider does not receive

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[38] Section 710(a)(2)(C). If the service provider purchases the ISPI, however, the rule characterizing loss with respect to an ISPI as ordinary does not apply until the aggregate losses allocated to the service provider exceed the service provider's basis at the time of the purchase. See Section 710(a)(2)(D).

[39] Section 710(b)(1).

[40] Section 710(b)(2).

[41] Section 710(b)(4).

[42] Section 710(c)(2)(A).

invested capital credit for any capital contribution that represents the proceeds of a loan made or guaranteed by the partnership or another partner of the partnership.[43]

The Bill defines an ISPI as any partnership interest held by a person that directly or indirectly provides a substantial quantity of any of the following services with respect to certain categories of "specified assets" held by the partnership, among them stock, debt, notional principal contracts, real estate, commodities, options and various derivative contracts:[44]

- advising on the purchase or sale of such assets;
- managing, acquiring or disposing of such assets;
- arranging financing with respect to such assets; or
- any supporting activity related to these services.[45]

To prevent circumvention of the Bill, special rules apply to the acquisition of certain ownership interests other than a partnership interest.[46] These rules, the scope of which are not at all clear, apply to the grant of a "disqualified interest" to certain service providers. For this purpose, a "disqualified interest" includes stock in an S corporation, convertible debt, options, derivatives and other arrangements the value of which is attributable to the provision of such services. Finally, the bill authorizes regulations[47]

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[43] Section 710(c)(2)(D).

[44] Section 710(c)(1).

[45] Id.

[46] See Section 710(d).

[47] Section 710(e).

and provides special relief to REITs and to publicly-traded partnerships in which a REIT holds 50% or more of the equity.[48]

B. Anti-Fee Deferral Bill

Although § 409A of the Code applies to fee deferrals by managers of investment funds, it does not prohibit fee deferrals. Moreover, § 409A applies without regard to whether the service recipient foregoes any tax benefit from the compensation expense. Proposed Section 457A would impose an outright prohibition on such deferrals under specified conditions. In particular, Section 457A addresses the special case where the offshore service recipient provides nonqualified deferred compensation to a taxable service provider but derives no tax benefit in the United States or elsewhere from paying the compensation on an earlier date.[49]

Proposed Section 457A would prohibit a manager, whether on the cash or accrual method of accounting, from deferring the receipt of compensation from any service recipient that is a "non-qualified entity." The manager is instead subject to tax on the date on which the right to such compensation is no longer subject to a substantial risk of forfeiture. For this purpose, proposed Section 457A defines a "non-qualified entity" as a foreign corporation unless "substantially all" of the income of the corporation is effectively connected with a U.S. trade or business or subject to "comprehensive foreign income tax."[50] A non-qualified entity also includes a foreign or domestic partnership

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[48] The REIT changes would apply under a new paragraph (8) added to § 856(c).

[49] See Senate Finance Committee staff summary of S. 3335 ("The bill would tax individuals on a current basis if such individuals receive deferred compensation from a tax indifferent party.").

[50] Section 457A(b)(1).

unless "substantially all" of the income of the partnership is allocable to persons other than (i) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax; or (ii) tax-exempt organizations.[51]

Proposed Section 457A defines a "comprehensive foreign income tax" as the income tax of a foreign country if (i) such person is eligible to claim the benefits of a comprehensive income tax treaty between such foreign country and the United States; or (ii) such person demonstrates to the satisfaction of the Secretary that such foreign country has a comprehensive income tax.[52]

V. Technical Issues with the Bill

A. Carried Interest Bill

Much of the public commentary on the Bill ignored the technical issues,[53] focusing instead on the broader policy question of whether fund managers should bear tax at long-term capital gains rates on service-related income. The lower tax rate available to those employed in the fund sector follows by direct application of the principles of Revenue Procedure 93-27 to an investment partnership. In such a partnership, the service provider will bear tax at recurring rates as low as 15% so long as

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[51] Section 457A(b)(2). Section 457A also excludes short-term deferrals where the service provider receives the compensation within 12 months of the end of the taxable year of the service recipient during which the right to the compensation is not subject to a substantial risk of forfeiture.

[52] Section 457A(d)(2). The original bill also required that the foreign tax regime provide rules for the deductibility of deferred compensation similar to those that govern deferred compensation in the United States. See H.R. 4351, AMT Relief Act of 2007.

[53] See, e.g., "Private Equity Tax Breaks, a Call to Be Up in Arms," *Washington Post* (Sept. 9, 2007); "Equity for Private Equity; Legislation to Raise Taxes on Fund Manager's Income," *Washington Post* (July 13, 2007); "Raising Taxes on Private Equity," *New York Times* (June 25, 2007); "Wealth Money Managers Make More, Get Taxed Less," *USA Today* (July 23, 2007); "Equity Managers' Loophole; Billion-Dollar Breaks," *Philadelphia Inquirer* (Sept. 19, 2007); "Alternative Tax Showdown," *New York Times* (Nov. 8, 2007).

the partnership achieves its primary business objective, which is usually to dispose of appreciated stock or other portfolio investments at regular intervals. Policy considerations aside, however, the Bill presents a number of technical issues.

Before addressing these issues, we first wish to emphasize that the drafters of the Bill deserve credit for identifying a basis of taxation in this realm that both captures the compensatory element of a profits interest yet avoids double taxation, a problem unique to partnerships and other pass-through entities. Indeed, practitioners have cited the problem of double taxation in the partnership context in defense of a rule that would ignore the compensatory nature of a profits interest ever since the Diamond case. The basic problem is as follows: if the grant of a profits interest is itself a taxable event, the service provider incurs an immediate tax even though it has only received illiquid property. In this regard, the tax consequences to the service provider are no different from the tax consequences under § 83 to any other service provider who receives property for services. Because the property in question is also a partnership interest, however, the service provider will bear tax again as the partnership realizes the future profits, even though the service provider has already reported the present value of those profits as income on the date of grant. Because double taxation is anathema to partnerships, Subchapter K provides a number of special rules in the non-service context to avoid it.[54]

The Bill addresses the problem of double taxation by borrowing a principle from the taxation of options: it suspends taxation of the service element, yet without altering

[54] See, e.g., IRC § 754.

the current status of the service provider as a partner and without overriding the principles of Revenue Procedure 93-27. Although the service provider will still bear tax at ordinary income rates on the future allocations of income --

- the service provider will avoid current tax on the grant of a profits interest, deferring the recognition of income until the issuing partnership realizes the future profits;
- the service provider will avoid current tax on the vesting of a profits interest; and
- the non-service partners will avoid tax on the income allocated to the service provider (rather than bearing the tax by including it in income and paying it over to the service provider as a potentially non-deductible § 212 expense).

By suspending the service element, the Bill preserves these three features of current law. On the date of realization, however, the Bill closes the service element, converting partnership income into service income as it passes from the partnership to the service provider. By converting less than the entire allocation, however, the Bill also adds a new layer of complexity to a tax regime that is already formidably complex.[55] As described more fully below, the task of implementing the basic principles of the Bill in a manner that fairly captures the service element of the grant is a daunting one, and is likely to require extensive regulatory guidance.

1. The Definition of Invested Capital

(a) "Subdividing" the Service Provider's Distributive Share

[55] Some regarded subchapter K as impenetrable even *before* Treasury promulgated the Section 704(b) regulations. See Foxman v. Comm'r, 41 T.C. 535, 551 (1964) ("The distressingly complex and confusing nature of the provisions of Subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field ... Surely, a statute has not achieved 'simplicity' when its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries.").

Much of the complexity of subchapter K derives from the flexibility it offers to a business venture: it permits various providers of capital and services to "pool" their separate contributions within a single entity, yet avoid entity-level tax on the aggregate profits. Indeed, it is this "aggregate" aspect of subchapter K that many cite as the primary virtue of the partnership form.[56] If enacted, however, the Bill will require an affected partnership to disaggregate the very pooling that subchapter K envisions. Indeed, we believe it is for precisely these reasons that the drafters sought to limit the scope of the Bill to partnerships that allocate significant amounts of capital gain to their service partners, often on a recurring basis.

The Bill provides for disaggregation under the exception for "invested capital."[57] Under the Bill, the portion of a service provider's distributive share that is treated as attributable to invested capital under the Bill is exempt from recharacterization and therefore remains taxable to the service provider in accordance with its underlying character.[58] The basis for the exception is both clear and intuitively compelling: a partner who contributes capital to a partnership will bear tax on partnership income on the same basis as any other partner who contributes capital. If the same partner also contributes services, it should not be taxed as though it had contributed only services.

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[56] See Regs. § 1.701-2(a) ("Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax") (emphasis added).

[57] Section 710(c)(2).

[58] Section 710(c)(2)(A)(ii). A similar exception applies to gain or loss "allocable" to invested capital on a sale or other disposition. See Section 710(c)(2)(B).

The Bill therefore recasts as service compensation only the portion of the total distributive share of the service provider as exceeds the portion attributable to his capital.

The Bill implements this distinction by subdividing the service provider's distributive share of partnership items under § 704(b) into separate "streams" of service and capital income. As such, it does not alter the current treatment of the grant of a profits interest as a tax-free transaction. Moreover, the issuing partnership continues to allocate profit and loss to all of its partners in accordance with the principles of § 704(b) and § 704(c), preserving the current law timing of profit and loss to the service provider.

Accordingly, it is invested capital that establishes the "base" for computing the portion of the service provider's future distributive share that will retain its character at the partnership level. The Bill defines invested capital as "the fair market value at the time of contribution of any money or other property contributed to the partnership".[59] As described more fully below, however, this definition is far too restrictive. By limiting the service provider's capital to what the service provider "contributes" to the partnership, the Bill will grossly overstate the service element of an ISPI. We believe that invested capital should also include the following two components:

- income allocated to the service provider but retained by the partnership; and
- income recognized by the service provider upon receipt of an ISPI.

Some of us also believe that invested capital should include the price paid by a service provider to acquire an ISPI from another partner.

(b) Earned Capital

[59] Section 710(c)(2)(C).

As described above, the Bill grants invested capital credit for property "contributed to" the partnership by the service provider.[60] It does not grant invested capital credit for any adjustments to the service provider's capital account attributable to previously-taxed income. As a policy matter, capital in the form of previously-taxed income of a partnership is indistinguishable from capital contributed to a partnership. Indeed, the capital that a service provider contributes to a partnership is likely to represent previously-taxed income of the service provider from another source. As presently drafted, the Bill will only encourage tax-motivated distributions earmarked for future reinvestment merely to extend invested capital credit that the service provider is entitled to in the first place:[61]

> *Example 1*: A and B form X, a partnership, with an aggregate contribution of $1000. Upon formation, X grants a 20% carried interest to GP for services. The GP's initial share of total capital is 0%. After investing the entire contribution, X realizes a $1000 gain and reinvests the proceeds. Immediately after allocation of the gain, the GP's share of the aggregate capital accounts is 10% (i.e., 200/2000). Under the Bill, however, *none* of the $200 qualifies as "invested" capital. Had X instead distributed the $200 to GP, GP could have reinvested the funds in X to establish $200 of invested capital.

In this example, GP is allocated 20% of the gain at a time when it has no invested capital in X. Under the Bill, GP will therefore bear full tax at ordinary rates on $200. Once the $200 is includible in GP's income, however, it becomes indistinguishable from any other capital that GP may invest in X. It is difficult to identify any rational basis for

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[60] Id.

[61] If the partnership has creditors, however, the debt covenants may prohibit these distributions.

this distinction.[62] We therefore recommend that the Bill expand the scope of the invested capital exception to include the service provider's share of previously-taxed income.[63]

(c) § 83 Inclusions on Grant

As described above, the Bill permits a service provider who invests capital in a partnership to report the allocations of income attributable to the capital in accordance with their underlying character. Under the Bill, however, a service provider receives invested capital credit only if the service provider "contributes" cash or property to the partnership.[64] If the service provider instead receives a fully taxable grant of a "capital interest" from the partnership, he receives no invested capital credit for the amount includible in income under § 83. We are not aware of any policy rationale for awarding less invested capital credit to the service provider upon the taxable grant of a capital interest than upon the direct purchase of a capital interest for cash or other property.[65] The Bill should grant the same invested capital credit to the service provider in each case.[66]

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[62] Under § 705(a)(1)(A) of the Code, previously-taxed income increases outside basis. Accordingly, the distribution of a like amount of cash will rarely trigger § 731 gain. Even if it would, the avoided gain is not a basis for denying invested capital credit. Indeed, any future § 731 gain may itself be taxable as service income. See Section 710(b)(1).

[63] The Bill should also reduce the service provider's share of previously-taxed income by the service provider's share of previously-taxable losses, whether or not such losses reverse prior allocations of such income.

[64] Section 710(c)(2)(C).

[65] Assuming that the service provider reports the grant of a capital interest at liquidation value, the amount taken into income upon grant should coincide with the amount credited to invested capital. As discussed more fully in section V.A.2(c) of this Report, we recommend either mandatory or optional reporting of all service grants in this context at liquidation value.

[66] The implications of granting invested capital credit in the case of a taxable grant of a profits interest, however, are considerably more complex. See section V.A.2(c) of this Report.

(d) Effect of Distributions

The Bill does not address whether a partnership must adjust the invested capital balances of its partners to reflect distributions and, if so, when and under what conditions. The proper accounting for distributions will depend in substantial part upon whether and how the Bill grants invested capital credit for previously-taxed income, "purchased" capital, and § 83 inclusions upon grant. As described more fully in section V.A.2(b) of this Report, it will also depend upon how the Bill coordinates these rules with intervening "revaluations" of capital (if any).

Adjusting invested capital balances to reflect distributions will introduce significant complexity, and will likely require regulatory guidance. Consider the following examples:

> *Example 2*: A and B each invest $100 in P, a partnership. P acquires property X with the proceeds. P allocates profits equally to each partner, except that B receives an annual guaranteed payment for services. Assume that P breaks even each year (net of the guaranteed payment), but that property X appreciates to $400. Assume that P then borrows $200 and distributes $100 to each partner. Following the distribution, each partner would appear to have no remaining "invested capital" in P. Nevertheless, B's distributive share of future income from the partnership (other than the guaranteed payment) should still be considered attributable to invested capital.[67]
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> *Example 3*: Assume the same facts as in Example 2, except that P borrows $100 and distributes the entire amount to B in redemption of one-half of B's interest. If P charges the entire distribution to B's invested capital, it will reduce the balance to zero. However, B should have at least one-third of the aggregate invested capital after the redemption. ((200 - 100)/(400 - 100)).

[67] Each of A and B would have $100 of invested capital in P even after the distribution so long as the Bill charges the entire distribution to unrealized gains. For a more complete discussion of the treatment of unrealized gain as invested capital, see section V.A.2(b) of this Report.

Example 4: A, B and C each contribute $100 to P, a partnership. P allocates one-third of the profits to each member, subject to a 20% carried interest to C for services. In year 1, P earns $30 of taxable income, and allocates $8 ((30 - 6)/3) to each of A and B and $14 to C (8+(20% x 30). P distributes an aggregate amount of $30 to A, B and C in the same ratios. What are the invested capital balances of A, B and C immediately after the distribution? If the $30 of taxable income qualifies as invested capital, A, B and C should still have $100 of invested capital. If it does not, then some sort of ordering rule will be necessary for debiting earnings or invested capital with distributions. Presumably, a partnership should first charge distributions against previously-taxed earnings.

(e) Purchased Capital

The Bill does not address how much invested capital to impute to the buyer of an ISPI from another partner. Under the Bill, the invested capital of the buyer probably includes the invested capital of the seller at the time of sale.[68] The buyer receives no additional credit for the difference, if any, between the amount paid for the ISPI and the invested capital of the selling partner. To the buyer, however, the acquired ISPI is similar to a newly-issued ISPI. A rule that conditions invested capital credit upon the identity of the seller may be unwarranted:

Example 5: A and B form a partnership with aggregate contributions of $1000. Upon formation, the partnership grants a 20% carried interest to SP-1 for services. SP-1's share of total initial capital is 0%. When the assets of X are worth $2000, SP-2 acquires the interest of SP-1 for $200. It appears that SP-2's invested capital credit is zero (i.e., the amount of SP-1's invested capital).

Example 6: same facts as Example 5, but rather than acquire the carried interest from SP-1, SP-2 acquires a similar interest from the partnership for $200, which the partnership reinvests in the business. Under the Bill, SP-2 receives $200 of invested capital credit.

[68] Even this is not clear. See Section 710(c)(2)(A)(i) (granting invested capital credit when "a portion of an [ISPI] is acquired on account of a contribution of invested capital ...") (emphasis added).

In both examples, SP-2 has paid $200 for the carried interest. Moreover, the economic terms of each carried interest are similar.[69] In Example 5, however, the Bill would deny invested capital credit to SP-2 because SP-2 did not transfer the $200 to the partnership. Under the Bill, SP-2 will therefore bear tax on all future allocations of income at ordinary income rates, regardless of its character at the partnership level.

Note that § 754 provides inadequate relief to SP-2 in Example 5.[70] If a valid § 754 election had been in effect in that example, the resulting basis step-up under § 743(b) would have reduced the aggregate amount of SP-2's distributive share of future partnership taxable income by no more than $200, regardless of its character under the Bill. It would not have reduced the amount or altered the character of any income *in excess of* $200. This is consistent with the separate and distinct purpose of the § 754 election, which is to protect SP-2 from bearing tax a second time on income already taxed to another partner. As such, the basis step-up under § 743(b) cannot serve as a proxy for invested capital because it will not insulate any of the future income from recharacterization as service compensation.

In Example 5, the buyer purchased an ISPI from another partner in a taxable transaction.[71] Congress should consider whether the Bill should grant invested capital

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[69] The principal difference to SP-2 in the two examples is that the partnership has an extra $200 of cash in Example 6. If the partnership had immediately distributed the $200 of cash to SP-1 in Example 6, the contribution and distribution would be vulnerable to recharacterization as a "disguised sale" of a partnership interest from SP-1 to SP-2 under § 707(a)(2)(B).

[70] But see Schler, "Taxing Partnership Profits Interests as Compensation," 2008 *Tax Notes* 829, 850-51 (May 26, 2008) (hereinafter cited as "Schler").

[71] Providing $200 of invested capital credit in Example 5 is appropriate because (i) SP-1 recognized $200 of service income in the sale; (ii) the $200 of income corresponds to the service income SP-1 would have recognized had the partnership sold its assets immediately before the sale and allocated a share of the gain to SP-1; and (iii) SP-2 would have acquired the interest with $200 of invested capital credit had SP-1

credit to the buyer under these conditions,[72] even though the issuing partnership did not receive the purchase price. The grant of invested capital credit in this context is not unlike the grant of a basis adjustment under § 743(b) to the buyer of an outstanding partnership interest. Here, however, the purpose of the credit is to shelter future income of the buyer from service taxation, not to shelter income taxed to the seller from any further tax at all.[73] If the Bill does grant invested capital credit, the same rules that apply to the purchase of a newly-issued ISPI should apply to the purchase of an outstanding ISPI for purposes of determining the "reasonableness" of any subsequent allocations of income to such capital.[74]

(f) Interim Allocations

One further complexity that an expanded definition of invested capital will introduce relates to interim profit and loss allocations within a taxable year. Although a partnership earns income and incurs expense on a daily basis, it generally determines and

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recognized such income before the sale of the partnership interest. See section V.A.1(b) of this Report (assumes that Bill grants invested capital credit to previously-taxed income). Some of us believe that the buyer should not receive any credit, in part because the purchase price for the acquired interest may not reflect fair market value and in part because implementing the adjustment in this context will add too much complexity.

[72] For the reasons described in section V.A.2(c) of this Report, Congress should limit the invested capital credit in this context to the lesser of the amount paid for the acquired interest or its liquidation value. In addition, the amount paid for the interest should include only the consideration that would have qualified as invested capital had the buyer contributed the consideration to the partnership (e.g, liabilities of the partnership included in the basis of the transferee should not be taken into account).

[73] The buyer in this context is likely to acquire an interest in the general partner rather than the investment partnership itself if the buyer is a service provider. Under these circumstances, the Bill should authorize regulations to permit the buyer to "tier-down" its invested capital in the general partner to the investment partnership. See, e.g., Rev. Rul. 92-15, 1992-1 C.B.215 (applying similar principles to a basis step up in a tiered-partnership under § 754). For a more complete discussion of issues with invested capital in tiered-partnership structures, see section V.A.9. of this Report.

[74] Note in particular the discussion in section V.A.2(b) of this Report regarding the determination of relative invested capital when various partners contribute capital at different times or at different prices to reflect intervening appreciation or depreciation in the partnership assets.

allocates taxable income as of the end of the taxable year.[75] But if the Bill defines invested capital of the service provider to include both contributed capital and previously-taxed income, the service provider's share (and therefore its potential share of future service income) may be viewed as varying over the course of the year, in many cases on a daily basis. This will raise a number of questions, including --

- how should a partnership apportion interim items of income allocable to the service provider between invested capital and services?
- should it depend upon how much capital the service provider has in the partnership when the income is realized? If so, how should the bill police "stuffing" by the service provider before the realization event?
- would it make sense to establish specific times during the year for establishing the relative capital attributable to an ISPI (e.g., at the beginning of the taxable year)? If so, would regulations be necessary to prevent abuses? Should such regulations follow the principles of § 706?

For some funds, in particular those with finite lives that liquidate over time (e.g., a typical private equity, venture capital or LBO fund), most of the partnership capital will represent invested capital, not previously-taxed earnings. The capital of the service provider properly attributable to each portfolio investment in these funds will therefore tend to represent actual contributions of capital by the service provider. But other funds, in particular hedge funds and many real estate funds, routinely reinvest previously-taxed earnings in new portfolio investments.

For simplicity, we would recommend that the Bill require a partnership to determine a service provider's relative share of invested capital as of the end of each

[75] IRC § 706(a).

taxable year. First, it will not be clear until then whether the partnership has any net income to allocate to the service provider. Second, a partnership must otherwise adjust the "book" capital account balances of its partners at this time to reflect the effect of profit and loss allocations for the year.

(g) Administrative Considerations

We acknowledge that expanding the scope of the invested capital exception to give credit for both previously-taxed but undistributed earnings and income reported by the service provider upon grant under § 83, with correlative adjustments for distributions, taxable losses, and revaluations, will introduce substantial complexity.[76] As a policy matter, however, we believe that these changes are necessary to limit the scope of the Bill to income that is fairly attributable to services. Moreover, most of the necessary architecture for capturing these adjustments already exists in subchapter K. We believe that Congress and Treasury can achieve a comprehensive, workable and fair definition of invested capital through the basic regulatory scheme of the § 704(b) regulations, in particular the existing regime for maintaining book capital accounts.[77] A § 704(b) approach has the added advantage of simplifying many other aspects of the Bill,

[76] Many of these complexities would be present even without these modifications.

[77] Future regulations, for example, might equate the service partner's invested capital with its capital account under § 704(b), reduced by the portion of the such account attributable to untaxed § 704(b) profits. In this regard, (i) the issue of what percentage of the profits are reasonably allocable to invested capital would be unaffected (but with a better mechanism for comparing relative returns after intervening "book-ups"); (ii) distributions would generally be charged to invested capital; (iii) rules would have to be adopted to apportion book losses between the invested capital and service components of the aggregate capital account; and (iv) profits attributable to § 704(c) taxable income would have to shift from the service component to the invested capital component of the book capital account.

including accounting for distributions,[78] applying the "reasonable allocation" rule (discussed below) and adjusting for non-pro rata capital contributions and distributions that may occur after the assets of a partnership have changed in value. It should also reduce incentives of affected taxpayers to engage in purely-tax motivated behavior.

2. The "Reasonable Allocation" Requirement

The benefit of the invested capital exception requires not only that a service provider contribute capital to a partnership, but that a partnership also make "a reasonable allocation of partnership items between the portion of the [service provider's] distributive share that is with respect to invested capital and the portion that that is not with respect to invested capital."[79] As described in section V.A.1. of this Report, the definition of "invested capital" is far too narrow. Even if the Bill were to broaden the definition of invested capital, however, it would still deny relief to the service provider unless the correlative allocations of income to such capital were "reasonable".

(a) The "All or Nothing" Cliff Effect

The reasonable allocation requirement appears to establish an "all or nothing" rule. In particular, if any portion of an allocation of income to invested capital is not reasonable, a service provider may not avail itself of the invested capital exception with respect to the portion that is reasonable. Cliff effects of this kind rarely reflect sound tax policy. In this context, it will only encourage service providers with invested capital to understate allocations of income to such capital that rightly qualify for pass-through

[78] Partnerships that make distributions, for example, will no longer need to establish whether the distribution represents a return of "invested" capital or a return of "earned" capital (an otherwise meaningless distinction).

[79] Section 710(c)(2)(A)(ii).

treatment. Even then, the Bill may disqualify an unduly conservative allocation due to other ambiguities in the rule (or by mere inadvertence or unintentional misvaluation). Congress should consider replacing the "all or nothing" rule with a rule that would treat only the "excess" portion of the allocation as service income. Alternatively, Congress should grant relief from the "all or nothing" rule for certain violations, in particular those involving either small or inadvertent variations from reasonable.

Nor does the statute address how a partnership should implement this determination. Presumably, the Bill will leave the determination to the discretion of the affected partnership. Some may choose to set forth the relative allocation to invested capital in the partnership agreement itself. Others may leave the determination to the general partner or managing member.[80] Also unclear is whether a partnership must determine the reasonableness of each allocation on an annual basis, or whether an unreasonable allocation in one year disqualifies an otherwise reasonable allocation in another. For example, if a partnership agreement specifies an allocation methodology, could a specified but demonstrably unreasonable allocation in a future year (should it ever occur) "taint" every other allocation under the partnership agreement? Presumably not, but anything is possible.[81] If the reasonableness of an allocation is instead determined annually, the Bill should only "test" allocations of income actually realized

[80] Because the service provider usually bears the full tax burden of the service allocation, it may be appropriate to allow the service provider to make this determination on his or her separate tax return.

[81] Precisely such considerations apply when assessing whether an allocation of income by a leveraged real estate partnership qualifies under the "fractions rule" of § 514(c)(9)(E). See Feder & Scharfstein, "Leveraged Investment in Real Property through Partnerships by Tax Exempt Organizations after the Revenue Act of 1987 – A Lesson in How the Legislative Process Should Not Work", 42 Tax Lawyer 55 (Fall 1988) ("if a theoretical violation [of the fractions rule] could ever occur the requirements of the test will not be met even if the contingencies which could cause violations are very unlikely to occur and actually do not occur").

by the partnership during the taxable year and reflected on the partnership tax return and Schedules K-1 of each partner. Note that a partnership may technically violate the reasonable allocation requirement not only by allocating too much income to invested capital, but too little as well.

(b) "Per Se" Unreasonable Allocations

To qualify for relief under the invested capital exception, an otherwise reasonable allocation of income must also overcome a presumption of unreasonableness. This presumption of unreasonableness treats an allocation as *per se* unreasonable if it "result[s] in the partnership allocating a greater portion of income to [the service provider's] invested capital than any other partner not providing services would have been allocated with respect to the same amount of invested capital."[82] As drafted, the presumption is irrebuttable. Moreover, if the service provider's return on invested capital exceeds the lowest return on invested capital of any non-service partner,[83] the "all or nothing" rule will treat the entire return as service income.

A *per se* rule of this type will often place the service provider with invested capital in a fund in an inferior tax position vis-à-vis a similarly-situated non-service partner who contributes a like amount of invested capital. Indeed, this rule will subject some service partners to excessive compensation income and exempt other service

[82] Section 710(c)(2)(A).

[83] See H.R. Rep. No. 728, 110th Cong., 2d Sess. at 20 (2008). The Bill appears to measure "return" for this purpose by comparing income allocated per dollar of invested capital, determined without regard to distributions. The legislative history offers the following example: Two non-service partners each contribute $1 million to a partnership and a service provider contributes $500,000. The three partners share profits equally. In a given year, the partnership earns $900,000 of taxable income. Under the *per se* rule, the partnership may allocate no more than $150,000 to the service provider's invested capital (i.e., that amount that provides the service provider with a rate of return on its invested capital ($500,000) equal to the 30% rate of return on the invested capital of the non-service partners ($1,000,000)).

partners entirely, in each case without regard to the underlying policy objectives of the Bill.

For example, a partnership must determine the relative invested capital of each partner on the date of each investment.[84] As drafted, therefore, the Bill appears to ignore the impact of prior appreciation or depreciation of capital on expected future returns. If the statutory language is construed to ignore such fluctuations, the return per dollar of invested capital on the same class of equity will vary from partner to partner unless each partner invests on the same date or at the same valuation. In any other case, a "cost" approach to comparing relative returns will inevitably lead to arbitrary and unintended results:

> *Example 7* (Pro-Service Provider): A and B invest $80 in P, a newly-formed partnership, in exchange for 100% of the partnership interests. At a time when the assets of X have increased to a value of $380, SP invests an additional $20 in exchange for 20% of the future profits. Because SP's share of the total "booked up" capital accounts on the date of investment is 5% ($20/($380+$20)), only one-quarter of the carried interest *should* qualify for relief under the invested capital exception. Under the Bill, however, SP, A and B are each entitled to 1% of the future profits *per dollar of invested capital.* SP's entire 20% carried interest therefore avoids recharacterization as compensation.
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> *Example 8* (Anti-Service Provider): A and B invest $380 in P, a newly-formed partnership, in exchange for 100% of the partnership interests. At a time when the assets of P have declined to a value of $80, SP invests an additional $20 in exchange for 20% of the future profits. Because SP's share of the total "booked down" capital accounts on the date of investment is 20% ($20/($80+$20)), the entire 20% carry *should* qualify for relief under the invested capital exception. Under the Bill, however, SP is entitled to 1% of the future profits per dollar of invested capital and A and B are each entitled to 0.2% of the future profits per dollar of

[84] Section 710(c)(2)(C) ("the term 'invested capital' means, the fair market value at the time of contribution of any money or other property contributed to the partnership") (emphasis added).

invested capital. Accordingly, 80% of SP's carried interest is recharacterized as compensation.

Although the relevant statutory language in the Bill is identical to the predecessor bill,[85] the legislative history to H.R. 6275 recognizes this issue and directs Treasury to clarify that "an allocation of income on invested capital does not fail to be treated as reasonable solely because of appreciation or depreciation in the value of partnership capital prior to the admission of new partners (provided service providers do not thereby convert their compensation to income on invested capital)".[86] Accordingly, we anticipate that future regulations will correct the problem identified in the preceding examples.[87] Moreover, taxpayers should be permitted to rely on this statement even prior to the issuance of such regulations.[88]

This rule is also likely to convert many nonabusive allocations of investment income into ordinary service income. In this regard, the specific types of nonabusive

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[85] See H.R. 3996, Section 710(c)(2)(A)(ii).

[86] H.R. Rep. No. 728, 110th Cong., 2d Sess. at 20 (2008).

[87] As discussed in section V.A.2(b) of this Report, similar revaluation issues arise after a non-pro rata distribution or redemption.

[88] We are concerned by an example in the legislative history illustrating the intended scope of these regulations. In the example, a partnership admits a second non-service partner to a partnership after the assets of the partnership have tripled in value. On the date of initial formation, a service partner had established a 50/50 partnership with another non-service partner, each contributing $1 million in cash in exchange for a partnership interest. The legislative history correctly observes that the service partner should have no future compensation income solely by virtue of the second non-service partner's later investment at a higher valuation. It goes on to state, however, that a pro rata allocation of future profits to the service partner "may fail to be treated as reasonable based upon other factors identified in Treasury guidance". Id. Given the stated facts, it is difficult to discern what "other factors" might alter this conclusion.

allocations bear a striking resemblance to common violations of the "fractions rule" under § 514(c)(9)(E).[89]

One such example is an investment partnership that permits an investor to "opt out" of a portfolio investment for regulatory or other non-tax reasons. When and if an investor exercises this right, the remaining investors will usually fund the shortfall in proportion to their relative capital commitments to the partnership, participating in the future gains on that particular investment at a correspondingly higher ratio. If the "opt out" investment produces a disproportionate gain, therefore, the foregoing presumption will treat the service provider's "excess" return on that investment as service income, even though the service provider may have funded the relevant capital on a fully-pro rata basis with the participating investors:

> *Example 9*: A, B and GP form a partnership, with each partner funding future capital contributions in the same ratio as they share future profits. B, however, reserves the right to opt out of any media investment. At the beginning of year 1, the partnership invests $600 in investment X and $400 in investment Y. Because Y is a media company, B opts out, requiring A and GP to fund the entire investment. Accordingly, A and GP have $400 of invested capital ($200 in each of X and Y) and B has $200 of invested capital (in Y). Assume that at the end of year 2, the partnership sells both investments, breaking even on X and realizing a $200 gain on Y. B earns a rate of return of zero. Accordingly, none of GP's $100 allocable share of the gain on Y will qualify as attributable to invested capital even though GP realized the very same return as A. If B had not

[89] The "fractions rule" provides limited relief from the debt-financed property limitations of § 514 to tax-exempt partners of leveraged real estate partnerships. One of the conditions to relief is that the tax-exempt partner's share of overall income in any taxable year never exceed its lowest share of overall loss in any taxable year, even on a theoretical basis. As described in a prior report, "there is broad consensus among practitioners familiar with this area that no provision of the tax law is more conceptually and technically flawed, more difficult and vexing to deal with, and more wasteful of taxpayer and government resources than section 514(c)(9)(E)." See New York State Bar Association Tax Section, "Report on Section 514(c)(9)(E) Concerning Investments in Leveraged Real Estate Partnerships By Pension Trusts and Other Qualified Organizations", 74 *Tax Notes* 1014 (Feb. 24, 1997).

opted out of Y, the entire $100 would have qualified as attributable to invested capital.

Similar anomalies arise in other situations. If a particular investor in a fund defaults on a capital commitment, for example, most funds will either permit or require the other investors to fund their proportionate share of the shortfall. If the "late" investor cures the default at a later date, the deferred capital contribution by the investor will often include an "interest" charge, which the fund will distribute to the other investors in the same proportions. Depending upon the relative performance of the particular investment, therefore, the return on capital to the late investor will differ from the return on capital to the remaining investors. In such a case, the lower of the two returns will set the ceiling on the service provider's permissible return on invested capital, again without regard to whether the service provider funded the capital attributable to each investment of the fund on a pro rata basis.

Finally, although the general partner will usually receive the same return on invested capital as the other investors in the fund, it may either "waive" the carry entirely or just pay the carry on its own capital to itself. Even this, however, would appear to violate the *per se* rule:

> *Example 10* ("Carry-Free" Capital): A and B form Fund, a partnership, with aggregate capital commitments of $400 each. Upon formation, X grants a 20% carried interest to GP for future services. GP also commits to contribute $200 of capital. GP does not charge a carry on its own capital. Fund invests $1000 and realizes a gain of $200 in year 1, allocating $64 to each of A and B ($200 x 40% x 400/1000) and the remaining $72 to GP ($52 + $20). A and B therefore earn a return of 16% ($464/$400) and GP earns a return of 36%. How much of the $72 should be deemed attributable to GP's invested capital? At least $32 ($200 x 16%), but why not $40 ($200 x 20%)? The Bill would appear to treat the additional $8 as service income, even though the GP is performing these particular services for itself.

A taxpayer cannot provide services to itself.[90] The "excess" return to the general partner on its own capital should therefore remain subject to tax in accordance with its underlying character.

We also note that the *per se* rule applies only to returns on capital of the non-service partners. A service partner may therefore earn a higher return per dollar of invested capital than another service partner, even if the other service partner is tax indifferent to allocations of service income and capital gain (e.g., a C corporation). In such a case, however, the allocation would still have to qualify as "reasonable" under the general rule.

The Bill also does not address how the *per se* rule should apply to a partnership that makes guaranteed payments for services to a service provider, guaranteed payments for capital to a non-service provider, or both. Nor does the rule distinguish between "excess" returns attributable to services and "excess" returns attributable to investment risk. An investment partnership with a senior/subordinated capital structure, for example, will often pay a different return per dollar of invested capital to its non-service partners simply because the capital of one subset of partners is senior to the capital of another. In fairness, the Bill should first take both of these variables into account before attempting to equate relative returns on capital:[91]

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[90] See, e.g., Comm'r v. Moran, 236 F.2d 595, 598 (8th Cir. 1956) ("an individual cannot be his own employee . . .").

[91] A rule that ignored guaranteed payments, for example, would prohibit a partnership from allocating any non-service income to a service provider regardless of its capital contribution merely because the partnership happened to distribute the entire return of a single non-service partner as a guaranteed payment.

Example 11: Assume that A, B and C form partnership P and that each partner contributes $1 million. Assume further that C provides services to P in exchange for a guaranteed payment. Because A is entitled to a priority return of capital, P allocates 25% of the future profits to A and 37.5% of the future profits to each of B and C. If P has $100 of income for the year (net of the guaranteed payment), only $25 of C's $37.50 distributive share may be attributed to its invested capital, converting the remaining $12.50 into service income. This is so even though B, who made the same investment as C and is not a service provider, received an allocation of $37.50 with respect to an identical amount of invested capital.[92]

Finally, the *per se* rule should ignore § 704(c) allocations,[93] minimum gain chargebacks, qualified income offsets and other "regulatory allocations" under the § 704(b) regulations. A rule addressing the impact of disproportionate loss chargebacks will also be necessary.[94]

In light of these concerns, we recommend that Congress strike the *per se* rule from the Bill. A general standard of "reasonableness", particularly if combined with a more temperate "all or nothing" rule, should provide ample incentive to service partners

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[92] Another troubling variant of this example arises if A, instead of receiving 25% of the profits, receives a fixed preferred return on invested capital. In such a case, P could allocate no more than A's preferred return to C's invested capital.

[93] Assume, for example, that a service provider contributes appreciated property to a partnership with a fair market value of $100 and a tax basis of $50. Assume further that the partnership sells the property for $110. The partnership recognizes $10 of book income and $60 of taxable income. The $50 of taxable income specially allocated to P under § 704(c) should not be taken into account because it is part of the service provider's invested capital on the date of contribution. See Section 710(c)(2)(C) ('invested capital' means, the "fair market value at the time of contribution of any money or other property contributed to the partnership"). Thus, the Bill should clarify that if partnership maintains book capital accounts in accordance with the rules of Regs. § 1.704-1(b)(iv), the presumption applies only to allocations of book income.

[94] Assume, for example, that A and SP form a partnership and that both partners contribute $1000. Assume further that A receives a preferred partnership interest and that SP receives a common partnership interest. Although A and SP share profits equally, the partnership allocates 100% of the losses to SP until its capital account is reduced to zero. Assume that the loss allocation to SP's invested capital is "reasonable" under the general rule. In year 1, the partnership loses $200 and allocates the entire loss to SP. In year 2, the partnership earns $200 of profit, which the partnership allocates to SP to "reverse" the prior loss. Under the draft legislation, it would appear that none of the $200 chargeback may be allocated to invested capital.

to adopt conservative allocations. If Congress retains the rule, it should exclude allocations to invested capital that do not exceed those attributed to some significant subset of non-service partners with similar equity interests in the partnership. Congress should also revise the Bill to ignore the contingent impact on relative returns attributable to "opt out" provisions of the type described above or to provisions in a fund agreement that compensate one group of non-service partners for the "late" capital contributions of another group of non-service partners.

(c) Coordination with § 83

An alternative to the "open transaction" approach of the Bill is to tax the service provider upon grant at ordinary income rates on the full fair market value of the ISPI. In the non-partnership context, this is the "quid pro quo" under § 83 for closing the service element of most compensatory grants of property. Implicit in the Bill is its wholesale rejection of this approach in the partnership context.[95] For the reasons set forth below, we agree that a traditional § 83 approach to taxing the service element of a profits interest is untenable in the partnership context, in particular in the case of a profits interest in an investment partnership.

The first of these problems is valuation. A pure profits interest is like an "at-the-money" option: the holder receives a share of the future gains in excess of an implicit

[95] See H.R. Rep. No. 728, 110th Cong., 2d Sess. at 17 (2008) ("The Committee understands that the Internal Revenue Service currently takes the position that the receipt of a partnership profits interest in not generally a taxable event to the partner or to the partnership ... As acknowledged by the Internal Revenue Service in taking this position, however, courts have reasoned that the value of the profits interest for services should be included in income on receipt, but valuation of these interests is often difficult due to factors such as the speculative nature of future business profits. Therefore, efforts to measure the amount of compensation for services by including in income the value of a partnership profits interest received for services at the time of receipt have not been successful. The Committee bill consequently takes a different approach ...) (emphasis added).

strike price equal to the current liquidation value of the fund. Given this economic similarity, the appraisal principles that govern the valuation of an option will govern the valuation of a profits interest as well. The Code has long recognized that most compensatory options, in particular options on illiquid property, have no readily ascertainable fair market value.[96] Depending upon the appraisal assumptions, therefore, the grantee of a profits interest will often have a menu of competing valuations at his or her disposal, many of which may be defensible as "reasonable". The bias of the service provider in this context, of course, will be to claim the lowest reasonable valuation as possible. Moreover, because much of the future income allocable to an ISPI is likely to qualify for taxation at preferential rates, the service provider will have an added incentive to claim the lower valuation. As in so many other contexts, a rule that would tax the receipt of property of uncertain value almost invariably leads to tax litigation. Although the Bill could temper the service provider's bias in favor of an unduly low valuation by imposing additional penalties, a large penalty only begs the question of proper valuation in the first place, which will rarely be apparent without the benefit of hindsight.[97]

A second (albeit related) problem in the fund context is distinguishing between value attributable to services and value attributable to existing goodwill, i.e., "founder's equity". Most investment funds call capital in stages over a multi-year investment

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[96] Regulation § 1.83-7 taxes the grant of a non-qualified stock option only if the option has a readily ascertainable value on the date of grant. Under this regulation, options that are not traded on an established securities market do not generally have a readily ascertainable value.

[97] Indeed, the "correct" fair market value of the interest should also reflect the value of the future services themselves. Otherwise, depending upon how the invested capital exception applies, the failure to take such value into account upon grant could result in the service provider ultimately bearing tax on the value of those services in accordance with the character of the allocated income at the partnership level, which appears contrary to the purposes of the Bill.

period; still others "reopen" the fund to admit new investors on an opportunistic basis. Assume, for example, that GP forms an investment partnership, P, with initial capital commitments of $10 million. Assume further that P grants a 20% carried interest to GP for services. Finally, assume that the carried interest has a fair market value of $250,000 upon grant based upon these commitments, which GP reports as ordinary income. After achieving above-market returns for several years, P decides to "reopen" the fund to new investors. In the reopening, new investors commit an additional $1 billion of capital to the fund on the same terms as the original investors. Is the reopening of the fund a taxable event to GP? If not, GP will have no additional income even though the carried interest now "carries" a vastly larger pool of capital. The failure to tax this incremental value as service income either at the time of the commitment or during future periods is difficult to reconcile with the stated policy objectives of the Bill.

One approach to addressing this concern is to require the GP to reflect the possibility of a future reopening in the value of the initial grant. Given the difficulty already inherent in valuing a profits interest, however, we do not believe that adjusting the initial value to reflect the possibility of future reopenings is viable.[98] Even if it were, taxing the service provider upon grant at a large valuation will grossly overtax any fund manager who either fails to reopen the fund or reopens the fund but generates insufficient gains to "earn" the carry on a realized basis. An alternative approach would be to treat the reopening as the grant of an additional carried interest. At this stage in the life of the fund, however, it will be difficult to distinguish between the value of the "constructive"

[98] Even if the valuation did reflect the possibility of a reopening, the additional gain may be negligible.

grant attributable to future services and the value attributable to preexisting goodwill of the manager entity.

A third problem is more technical in nature: the task of coordinating a conventional § 83 approach to the taxation of a profits interest with the competing principles of subchapter K. Subchapter K does not readily embrace principles like present value or option value.[99] It instead measures the value of a partner's equity interest in the business by capital accounts, requiring a partnership to reflect each partner's relative share of the net assets of the business at their current liquidation value. If, for example, a partner invests $50 in a partnership, the partner will have an opening capital account balance in the partnership of $50, regardless of whether the partner's share of the future profits is 10% or 90%. Moreover, the "substantial economic effect" of any later allocation of such profits will depend upon whether the allocation increases the partner's capital account, even if the partner is not entitled to all or any portion of his capital account balance until the partnership liquidates. If a partner receives a pure profits interest for services, therefore, subchapter K provides no place within the capital account regime to reflect the value of the granted interest on a current basis.

A traditional § 83 approach, on the other hand, would tax the service provider upon receipt at the fair market value of the property. If the property in question is a profits interest, therefore, traditional § 83 principles would tax the service provider upon receipt at ordinary income rates even though subchapter K would deny the service

[99] We have previously referred to subchapter K as a "sealed system". See New York State Bar Association Tax Section, "Report on the Proposed Regulations and Revenue Procedures relating to Partnership Equity Transferred in Connection with the Performance of Services," 109 *Tax Notes* 1311 (Oct. 26, 2005) (the "New York State Bar Association Tax Section Report on the Proposed Section 83 Regulations").

provider an opening capital account. It is here, therefore, that the two regimes conflict: the fair market value of property must reflect, at least in part, the entitlement of such property to future profits. The principles of § 83 will tax this "option value" even though subchapter K will grant no capital account credit.

Given the complexity of these issues, the Bill properly rejects a traditional § 83 approach to taxing the service element of an ISPI. But an ISPI is still "property" for tax purposes. The Bill nevertheless makes no effort to coordinate the rules of Section 710 with the principles of § 83. In particular, it does not grant "invested capital" credit for any amount includible in income under § 83 upon the grant of a partnership interest in exchange for services. Because both apply to the compensatory grant of an ISPI, they should be harmonized in some fashion to avoid double taxation of the service element.[100]

Under Revenue Procedure 93-27, the receipt of a profits interest in exchange for services is generally not a taxable event to either the service provider or the partnership.[101] The receipt of a capital interest in exchange for services is a taxable event.[102] Whether an interest is a profits interest or a capital interest depends upon

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[100] We refer to this phenomenon as "double taxation" throughout this Report. We should acknowledge, however, that the service partner will receive additional "outside" basis for the incremental income, resulting in a smaller gain or a larger loss upon a later sale or liquidation of the partnership. Given the potential timing and character differences, however, the present value of this offsetting tax benefit will often be quite small.

[101] Rev. Proc. 93-27, 1993-2 C.B. 343, as modified by Rev. Proc. 2001-43, I.R.B. 2001-34. In general, Revenue Procedure 93-27 provides that if a person receives a profits interest for services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner, the IRS will not treat the receipt of such interest as a taxable event to the partner or the partnership.

[102] The receipt of an unvested capital interest is not taxable to a partner until the interest vests (within the meaning of Regs. § 1.83-3(b)), unless the service provider makes a § 83(b) election. Both § 83 and § 61 treat the receipt of a substantially vested capital interest for services as a taxable event.

whether it has a positive "liquidation value" on the date of grant.[103] An interest has positive liquidation value if, immediately after the grant, the grantee would receive a share of the proceeds upon the hypothetical sale of the partnership's assets at their fair market value, followed by a liquidating distribution.

In May 2005, Treasury issued proposed regulations under § 83 concerning the grant of a partnership interest for services.[104] If finalized in their present form, the Proposed § 83 Regulations will confirm that both a profits interest and a capital interest in a partnership constitute "property" within the meaning of § 83.[105] The proposed § 83 Regulations will also obsolete Revenue Procedure 93-27, replacing it with a separate regulatory regime. Under the Proposed § 83 Regulations, a partnership that satisfies certain conditions may, subject to the unanimous and legally-binding consent of its partners, value a partnership interest issued for services at liquidation value.

As pointed out in our prior report,[106] it will be difficult for many partnerships to comply with the procedural limitations of the safe harbor, and a practical impossibility for others. The apparent (albeit unstated) rationale for these limitations is whipsaw: unless legally prohibited from doing so, a "maverick" non-service partner may claim the compensation deduction upon the grant of a profits interest to another partner, contending

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[103] A profits interest is any partnership interest other than a capital interest. Rev. Proc. 93-27, 1993-2 C.B. 343. Note that under Rev. Proc. 93-27, unrealized gains are taken into account in determining whether an interest is a capital interest. See also GCM 36364 (July 23, 1975) (to the same effect).

[104] See REG-105346-03, 70 Fed. Reg. 29675 (5/24/05) (the "Proposed § 83 Regulations"). Prop. Regs. § 1.83-3(l).

[105] Prop. Regs. § 1.83-3(e).

[106] See New York State Bar Association Tax Section Report on the Proposed Section 83 Regulations at p. 1313.

that § 83 does not sanction the use of liquidation value as a proxy for fair market value. Meanwhile, the partner who actually received the profits interest for services will rely on its zero liquidation value to avoid current income.

Under a fair market value approach to valuation of a profits interest, the service provider will bear immediate tax at ordinary income rates. In addition, it will be subject to tax on its allocable share of the underlying profits of the partnership in the future.[107] The service provider will suffer this consequence without regard to whether the profits interest in question is an ISPI. If it is an ISPI, however, a substantial component of the service provider's future distributive share is likely to consist of long-term capital gain or qualified dividend income otherwise taxable at a 15% rate. Under the Bill, therefore, the service provider's future distributive share of partnership profits will bear tax at a higher rate.[108] For service providers subject to the Bill, the objective of avoiding or at least mitigating double taxation is much more acute.[109]

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[107] For example, assume that A, B and SP form a partnership, with A and B each contributing $1 million and SP contributing future services. Assume further that the partnership allocates one-third of the future profits to each partner and that the fair market value of SP's profits interest on the date of grant is $150,000. If the partnership earns $900,000 over its lifetime, SP's distributive share will be $300,000, resulting in "double tax" to SP on $150,000 (pending recognition of a possible offsetting loss on liquidation).

[108] Including SECA tax.

[109] Other approaches to mitigating the problem of double taxation under a fair market value approach include permitting the partnership to amortize the amount taken into income by the service provider as a deduction and specially allocating the deduction to the service provider. A full discussion of how Congress or Treasury should mitigate the problem of double taxation under a fair market value approach to the taxation of a profits interest is beyond the scope of this Report. We note, however, that this approach will also require a number of adjustments and other technical "fixes" unrelated to double taxation merely to reconcile the approach with the competing principles of subchapter K, particularly as reflected in the § 704(b) (regarding maintenance of capital accounts) and § 707(c) regulations. See New York State Bar Association Tax Section Report on the Proposed Section 83 Regulations at p. 1315.

This in turn raises the issue of whether the service provider should receive invested capital credit for the amount taken into income under § 83 upon grant and, if so, how much of the future income should be attributed to such capital. Under the *per se* rule described in section V.A.2(b) of this Report, only a portion is likely to qualify. Indeed, depending on the particular facts, that portion may be relatively small. In such a case, most of the future income allocable to the profits interest will constitute service income even though the service provider will have already reported the full fair market value of the profits interest as service income on the date of grant.

Both the problem of double taxation and the concomitant issue of whether an allocation to invested capital is "reasonable" will arise in the case of a pure profits interest *only* if the service provider values the grant at fair market value. If the service provider values the profits interest at liquidation value, it will avoid immediate tax[110] and will receive no invested capital credit. The issue of whether any future allocation of income to such capital is "reasonable" is therefore academic. As described above, however, the right to value a profits interest at liquidation value will not be available to many partnerships by virtue of the unanimous consent requirement of the Proposed § 83 Regulations.

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[110] Under a liquidation value approach, the service provider incurs no tax upon the grant of a profits interest. If a partner instead receives a capital interest for services, the partner should be treated as though it had received cash compensation equal to the liquidation value of the capital interest and then contributed the cash back to the partnership. In such a case, the service partner would have an initial capital account equal to the § 83 income inclusion. Moreover, "reverse" § 704(c) principles should protect the service partner from any built-in gain inherent in the partnership's assets on the date of grant. See Regs. § 1.704-1(b)(2)(iv)(f)(5)(iii) (providing for elective revaluation of partnership assets upon the grant of an interest in a partnership in connection with the performance of services). See also Regs. § 1.704-3(a)(6) (applying the principles of § 704(c) to reflect differences between book value and tax basis arising on a revaluation of partnership property pursuant to Regs. § 1.704-1(b)(2)(iv)(f)).

We therefore recommend that Congress couple any legislative proposal in this area with an amendment to § 83 that would expressly sanction the use of liquidation value upon grant of an ISPI.[111] By establishing a clear statutory basis for liquidation value, the amendment would allow affected partnerships to make the election on behalf of all partners free of the procedural constraints of the currently-proposed safe harbor.[112] Alternatively, as we have recommended in a prior report,[113] Congress might amend § 83 to compel the use of liquidation valuation, at least in the case of any partnership subject to the Bill. We believe this would greatly simplify the tax treatment of compensatory grants in the partnership context and the coordination of the competing principles of § 83 and subchapter K.[114]

Should Congress decline to compel the use of liquidation value by statute, the fair market approach under the Proposed § 83 Regulations should not permit the service provider to shield all or substantially all of the future income allocable to an ISPI from service taxation. We therefore recommend that the Bill cap any invested capital credit associated with the taxable grant of an ISPI at the liquidation value of the interest. The grantee of an ISPI that is a pure profits interest will therefore receive no invested capital

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[111] The amendment might apply to all service grants of a partnership interest or only to service grants of a partnership interest in the form of an ISPI.

[112] An express statutory basis for the election should also eliminate any residual IRS concerns about "whipsaw", the apparent rationale for many of the procedural limitations of the safe harbor.

[113] See New York State Bar Association Tax Section Report on the Proposed Section 83 Regulations at p. 1314.

[114] Under a liquidation value regime, the service provider should be permitted to ignore the value of the future services themselves because it is under no obligation to provide those services in this context.

in the partnership regardless of the amount reported on the date of grant as ordinary income.[115]

3. Partner to Partner Loans

Under the Bill, a service provider receives no invested capital credit for any capital contribution "attributable to the proceeds of any loan or other advance made or guaranteed, directly or indirectly, by any partner of the partnership".[116] Thus, if a service provider borrows $100 from another partner and contributes it to the partnership as a capital contribution, the service provider will receive no invested capital credit. This provision applies by its terms to any loan to a service provider made or guaranteed directly or indirectly by any partner, regardless of whether the loan is recourse or otherwise provides for arm's-length terms.

The apparent purpose of the partner loan exception is to prevent service providers from circumventing or inappropriately mitigating the intended effect of the Bill by borrowing capital on a subsidized or non-arm's length basis and imposing the economic burden of the subsidy on the lending partner. In effect, certain types of loans grant the equivalent of a carried interest in favor of the service partner against the lending partner. For example, if a service provider, SP, contributes $100 to an equal partnership with A (who also contributes $100) funded solely by a non-recourse 8% loan from A, the economics are essentially indistinguishable from the grant of a 50% profits interest to SP

[115] Consistent with this approach, we would also recommend that a purchaser of an ISPI not receive any invested capital credit for any amount paid to either the issuing partnership or another partner in excess of the liquidation value of the purchased interest.

[116] Section 710(c)(2)(D).

subject to an 8% preferred return in favor of A.[117] When the loan is on arm's-length terms, however, this exception is hard to justify. The service provider receives no economic subsidy whatsoever and the lending partner suffers no economic detriment.[118]

A possible justification for the overbreadth of the loan exception is that the IRS cannot easily assess whether a loan between partners is truly arm's-length. In determining whether a loan is arm's-length, potential considerations include not only the interest rate on the loan, but also the maturity of the loan, whether the interest is payable on a current basis, the nature of the remedies on default, whether the loan is fully recourse, and the sufficiency of the borrower's other assets.

We appreciate this concern. Indeed, if a service provider has the capacity and willingness to borrow on a purely arm's-length basis, it may avoid these limitations entirely by simply borrowing the funds from a bank or other commercial lender. As an alternative, however, Congress might exempt a loan from a partner that is arm's-length, with the burden of proof on the service provider to establish that it qualifies for the exemption by clear and convincing evidence.[119] In this context, Congress might also grant regulatory authority to (i) disqualify certain loans that fail to satisfy specific conditions; and (ii) establish safe harbors for others. For example, future regulations

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[117] In such a case, if the partnership has $20 of taxable income, A would receive $16 as a preferred return on capital and $2 as residual profit and SP would receive $2 with respect to its carried interest. By effecting the arrangement as a loan, A is instead allocated $10 with respect to its 50% partnership interest and receive $8 of "interest", leaving SP with the remaining $2. In both cases, A bears all risk of loss.

[118] If another partner guarantees the loan without compensation, there may also be potential for a subsidy. If the borrowing partner has substantial assets and the loan is fully recourse, however, the value of the guarantee would typically be quite small.

[119] For a loan that is not arm's-length, consideration should be given to granting partial invested capital credit. For example, the proceeds of a loan bearing a below-market rate of interest might provide invested capital credit equal to the "imputed principal amount" of the loan under § 1274.

might disqualify any loan that is either convertible into equity of the partnership or provides other "equity kickers" in the partnership. A possible safe harbor might grant relief to any otherwise qualified loan that is either fully recourse to a borrower with substantial assets or adequately secured by assets of the borrower with an equity value sufficiently in excess of the loan (e.g., 2-to-1). Other possible safe harbor criteria include the maturity date of the loan, whether the loan requires the current payment of interest, whether the interest rate on the loan exceeds a minimum stated rate (e.g., the AFR plus a margin)[120] and whether the loan is subordinate to other debt.

It should also be noted that the loan exception applies to a loan from any partner, regardless of the lending partner's interest in the partnership. A loan from a small partner (assuming it is not matched by pro rata loans from the other partners) bears none of the hallmarks of a disguised carried interest. Moreover, a commercial lender, insurance company or other institution that lends money in the ordinary course of business to a service provider may trigger application of the Bill merely because the lender is affiliated with the same partnership. Consideration should be given to exempting these cases as well.

Another possible concern of the drafters is that the lending partner will not enforce the loan in accordance with its terms, particularly if the partnership is experiencing economic hardship. This could be addressed, however, by regulation or otherwise, by providing that any modification (or deemed modification) of the loan

[120] See, e.g., Regs. § 1.897-1(d)(4) (for purposes of determining whether a loan to a FIRPTA entity that is otherwise an "interest solely as a creditor" may be aggregated with other interests, FIRPTA regulations exclude loans with "arm's length" repayment terms that bear interest at a rate no greater than 120% of the applicable AFR under § 1274(d)).

would require the partnership to "retest" the loan. If the loan failed to qualify on the retesting date, the service provider's invested capital for future periods would be reduced accordingly. Any forgiveness of the loan should give rise to compensation income to the service provider.[121]

If the service provider contributes borrowed funds to a partnership in exchange for a partnership interest and does not receive invested capital credit for his contribution, the service provider should be permitted to deduct the interest expense on the borrowing against the compensation income realized by service provider with respect to the ISPI:

> *Example 12:* assume that a service provider borrows $100 at 8% from partner A and contributes the $100 to the partnership. Assume further that the service provider's allocable share of the income for the year is $10 and that the service provider pays $8 of interest to A. The service provider should have only $2 of compensation income, which is the same amount the service provider would have if he had not contributed capital and instead received a carried interest of $2.[122]

This provision applies not only to direct and indirect loans, but to direct and indirect guarantees of loans from a third party. The precise scope of the guarantee exception is unclear. Would a guarantee by a corporation owned 50% by a partner constitute an indirect guarantee by the partner? Would a guarantee by a corporation that owns 50% of a partner subsidiary constitute an indirect guarantee? What about a

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[121] See Regs. § 1.61-12(a) (individual who performs services for a creditor who then cancels the individual's debt as consideration realizes income from compensation for services). If it is established that a plan to forgive the debt existed on the date of issue, the service partner should either receive no invested capital credit from inception or incur immediate compensation income coupled with invested capital credit.

[122] Under current law, the interest expense is likely to constitute "investment interest" under § 163(d), which the service provider may elect to deduct against future allocations of long-term capital gain. If the underlying allocations constitute service income under the Bill, however, these limitations may no longer apply. See IRC § 163(d)(5) (definition of "property held for investment"). Future regulations should clarify, however, that any interest on a "disqualified" borrowing nevertheless reduces allocations of service income attributable to the ISPI on a dollar-for-dollar basis, both for income and employment tax purposes.

guarantee from a portfolio company of the fund? Future regulations should provide guidance.

4. Loans to Partnership by Non-Service Providers

Under the Bill, a loan to a partnership "made or guaranteed, directly or indirectly, by any partner not providing services, is treated as invested capital of such partner."[123] If any such loans are made to the partnership, the "amounts of income and loss treated as allocable to invested capital shall be adjusted accordingly."[124] The legislative history indicates that any invested capital credit imputed to the lending partner will dilute the portion of the services provider's distributive share of income and loss that qualifies as attributable to invested capital.[125] How the Bill effects such dilution, however, would appear to depend on the application of the "reasonable allocation" rules.[126]

> *Example 13*: A and SP each contribute $100 to a partnership in exchange for a 50% interest in profits. A also lends $100 to the partnership at an 8% rate. SP is a service provider and A is not a service provider. Assume that in year 1, the partnership has $20 of taxable income (net of the $8 interest deduction), of which $10 is allocable to SP under the partnership agreement.

Under the Bill, SP has $100 of invested capital and A has $200 of invested capital. What portion of SP's $10 of taxable income is allocable to invested capital? Under a strict interpretation of the unreasonable allocation presumption, the baseline is

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[123] Section 710(c)(2)(D)(ii).

[124] Id.

[125] H.R. Rep. No. 728, 110th Cong., 2d Sess. at 20-21 (2008).

[126] See section V.A.2. of this Report. Consider, however, whether different rules might apply for purposes of adjustments under this provision.

33.33% (since SP has only one-third of the invested capital), in which case only $6.67[127] of SP's taxable income would qualify.[128] If the loan is arm's-length, however, the entire $10 should qualify.[129]

The rule described above would not apply, however, if the lender itself is a service provider. Thus, in the preceding example, if A had been a service provider, SP and A would each be considered to have $100 of invested capital, and SP's share of invested capital would not be diluted. Accordingly, all $10 of SP's share of taxable income would qualify as allocable to invested capital.

As in the case of loans between partners,[130] Congress should consider granting relief to any arm's-length loan between a partner and a partnership. To address the difficulty of assessing whether the loan is truly arm's-length, the Bill might require the service provider to establish the eligibility of the loan for relief by clear and convincing evidence, subject to regulatory exclusions and safe harbors similar to those described in Section V.A.3. of this Report.

Unlike the rule for partner-to-partner loans, this particular provision applies only if the lending partner is not itself a service provider. Although the legislative history does

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[127] $20 x 1/3.

[128] If this approach is followed, however, the partnership should be permitted to add back the interest expense before multiplying it by the invested capital percentage, in which case SP's allocation to invested capital would be $9.33 ($28 x 1/3).

[129] As above, the $8 of interest expense should increase the income of the partnership for this purpose, and under the liberal interpretation of the unreasonable allocation rule, since a return of $8 is a reasonable allocation to invested capital under the loan, SP's entire share of the remaining $20 of taxable income should qualify.

[130] See section V.A.3. of this Report.

not explain the basis for this distinction, it may reflect a desire to avoid further complexity. If, for example, the rule were to apply to a loan from a service partner, should the lending partner receive invested capital credit in its own right? If not, should such invested capital only be taken into account for purposes of diluting the invested capital of the borrowing partner?

Given the limited scope of this rule, a non-service partner may be better off borrowing from a service partner than a non-service partner. This provides some potential for tax planning by purposely making the lending partner a service provider to minimize any adverse impact on the other service providers (particularly in cases where the lending partner (e.g., a C corporation) is otherwise indifferent to service provider status. Consideration should be given to anti-abuse rules to address this issue.[131]

5. Treatment of Distributions under § 731

As discussed above, the Bill generally treats gain from the disposition of an ISPI as ordinary compensation income.[132] This treatment does not apply, however, to the extent that the gain is allocable to invested capital.[133] In the case of a disposition, the gain allocable to invested capital is equal to the portion of any gain that would have been allocable to invested capital (presumably with respect to the interest disposed of) if the partnership had sold all of its assets immediately before the disposition.

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[131] As discussed more fully in section V.A.8(b) of this Report, this would not be necessary if the Bill ultimately exempts a domestic C corporation or other "tax indifferent" holder of an ISPI.

[132] Section 710(b)(1).

[133] Section 710(c)(2)(B).

Under § 731(a), a partner recognizes gain to the extent he receives a distribution of cash in excess of his basis in the partnership immediately before the distribution.[134] The distributee partner must report the gain as gain from the sale or exchange of a partnership interest. While the Bill does address the treatment of a partner with invested capital who sells an ISPI, it does not address the treatment of a partner with invested capital who realizes gain in a § 731(a) distribution. It would be reasonable, however, to exclude from service characterization the portion of the gain that would have been eligible for the invested capital exception had the service provider sold the ISPI immediately before the distribution. For example, the service provider might be permitted to treat the same percentage of gain recognized in the distribution as exempt from service characterization as would have been exempt had the service provider instead sold the ISPI to a third party for equivalent consideration.[135]

6. Distributions in Kind

As described above, the taxation of an ISPI as compensation for services applies at the service provider level. In general, therefore, the Bill has no tax impact on either the issuing partnership or the non-service partners of the partnership.[136] The Bill taxes the service element in this manner by respecting the service provider as a partner on the date of grant, and recharacterizing all or a portion of his future profits as compensatory.

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[134] Subject to various exceptions, a distribution of marketable securities may be treated as a distribution of cash for this purpose. See IRC § 731(c)(1).

[135] The appropriateness of this approach presupposes a coordinated set of rules for the adjustment of invested capital (and the income or loss allocable to invested capital) to reflect both proportionate and disproportionate distributions.

[136] As discussed in section V.A.9. of this Report, the purchase of an interest in a partnership that itself holds an ISPI in another partnership may alter the tax consequences to a non-service provider.

Accordingly, the Bill neither accelerates the realization of income at the partnership level nor alters how the partnership allocates such income among its partners. The Bill departs from this basic model, however, if the partnership distributes appreciated property.

If a partnership distributes appreciated property to the service provider, the Bill overrides § 731(b). As a result, the distributing partnership must recognize gain as if it had sold the property for its fair market value.[137] Any gain so recognized is taxable to the service provider as compensation.[138] Although the original bill also recast the distribution as a sale, it did not override the current law allocation of the gain under the § 704(b) regulations.[139] Accordingly, the service provider realized compensation income *only* on the portion of the realized gain allocable to it under the partnership agreement. The remaining gain was taxable to the non-service partners, even though the service provider received the entire distribution.[140] The service partner therefore avoided full taxation of the service element.

Consider the following example:

> *Example 14:* Two limited partners form X, an investment partnership, with a contribution of $3,000. X invests the proceeds in 10 shares of A. X then grants GP a 20% carried interest for services. At the end of year 5, when each share of A is worth $600, X sells the 10 shares and recognizes

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[137] Section 710(b)(4).

[138] Id.

[139] Compare H.R. 3996, Section 710(b)(4) ("gain shall be recognized by the partnership in the same manner as if the partnership sold such property") with Section 710(b)(4) (gain "shall be taken into account as an increase in such partner's distributive share ...") (emphasis added).

[140] A payment for services with appreciated property constitutes a sale of such property by the service recipient, and is also taxable as compensation to the service provider. See IRC §§ 1001, 83. Although the approach of the Bill is consistent with the first of those principles, it is only consistent with the second to the extent of the service provider's interest in the partnership. Moreover, it does not permit an offsetting compensation deduction to the service recipient. See Schler at p. 844.

> a $3,000 gain. Under the Bill, GP must report its $600 allocable share ($3,000 x 20%) as service income in spite of its character as long-term capital gain at the partnership level.
>
> Assume instead that X distributes *one* share of A to GP in retirement of the carried interest.

In this example, X must recognize $300 of gain under both the Bill and its predecessor.[141] Because current law governed the allocation of the gain under the original proposal, however, $60 was taxable to GP as service income (20% of $300) and $240 was taxable to the limited partners as capital gain (80% of $300).[142] Moreover, under § 732(b), GP's $60 "outside" tax basis in X attached to the distributed share, which maintained its status as a capital asset in the hands of GP. Accordingly, if GP were to sell the distributed share for $600, it would report $540 of capital gain.[143]

The drafters of the Bill recognized the obvious flaw in the original bill: as an economic matter, a non-pro rata distribution to a service provider is a sale that "closes" the service element; aggregate principles of subchapter K nevertheless allow the distributee partner to defer the gain so long as the distributed asset is neither cash nor a marketable security.[144] Had X sold its entire portfolio, or even made a leveraged distribution of cash to GP before such a sale, GP would have reported the entire $600 of gain as service income. But because the original bill neither taxed the full amount of the

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[141] H.R. 3996, Sections 710(a)(1)(A), 710(b)(4).

[142] IRC §§ 702, 1001.

[143] It should also be noted that X and GP both recognize gain on the distributed asset, first on its distribution and then on its subsequent sale. See Schler at p. 844.

[144] See IRC §§ 731-735.

distribution to GP nor "tainted" the distributed asset in its hands, GP was able to convert a full 90% of the $600 into capital gain.[145]

To capture the correct amount of service income, the Bill could have adopted one of three approaches:

- Alternative #1: recast the in-kind distribution as a deemed distribution of cash, followed by a purchase of the distributed property by the service provider from the partnership, allocating all of the gain on the deemed sale to the service provider; or

- Alternative #2: treat the distributed property as a "hot asset" in the hands of the service provider, but only to the extent of the unrealized gain in the distributed property immediately after the distribution.[146]

- Alternative #3: recast the in-kind distribution as (i) a deemed sale of the distributed property by the partnership, treating only the portion of the gain allocable to the service provider under § 704(b) as ordinary income; followed by (ii) a deemed sale of the ISPI by the service provider to the extent that its remaining economic interest in the partnership is reduced.

The Bill opted for the first alternative. In the preceding example, therefore, GP would report $600 of compensation income upon receipt of the distributed asset.[147] Having fully taxed the service element, the Bill would then grant GP a fair market value

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[145] See Schler at 844.

[146] See Abrams, "A Close Look at the Carried Interest Legislation", 2007 *Tax Notes* 961, 969 (December 3, 2007) (hereinafter cited as "Abrams").

[147] Section 710(b)(4)(A). The special allocation of gain to the service provider will increase the service provider's outside basis, and therefore reduce its gain on the deemed distribution under § 731(a). GP therefore recognizes $600 of service income in two parts: First, X allocates $300 of gain to GP on the deemed sale of the A share, increasing GP's outside basis to $300. Second, under § 731(a), GP recognizes an additional $300 of gain on the deemed distribution of $600.

basis in the distributed asset, without regard to its basis in the hands of X immediately before the distribution.[148]

Although the resulting special allocation of gain to the service provider may, depending upon the circumstances, violate the "substantiality" requirement of § 704(b), the Bill overrides that requirement in order to facilitate full taxation of the service element. Consistent with the Bill in other contexts, the special allocation also avoids any immediate tax consequences to the non-service partners.[149] Finally, a partnership with a valid § 754 election may apply existing principles of § 734 to adjust the inside basis of its remaining assets following a § 731(a) distribution of cash in excess of basis.[150] As such, the partnership will increase its inside asset basis by the appropriate amount, regardless of the amount of gain inherent in the distributed asset.[151] In the preceding example, X would increase its basis in the 9 retained shares by $300.[152] When X then sells the shares

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[148] Section 710(b)(4)(C).

[149] If the service provider has pre-existing tax basis in the partnership, however, the special allocation of gain will tend to overstate service income on the date of distribution because such basis would otherwise have absorbed a larger percentage of the deemed distribution of cash (at least in a partial redemption). See Schler at p. 844.

[150] See IRC §734(b)(1)(A). The Bill ensures that the special allocation of gain to the service provider will produce the "correct" inside basis adjustment because it applies § 734(b) without regard to the special allocation and resulting basis step-up to the service provider. See Section 710(b)(4) ("subsection (b) of section 734 should be applied without regard to the preceding sentence"). Accordingly, because GP would be deemed under § 732(b) to have reduced its basis in the distributed shares from $300 to zero, § 734(b)(1)(B) will increase GP's basis in the retained shares by a like amount.

[151] If the actual sale of the distributed asset by the partnership would have otherwise resulted in an allocation of ordinary income to the *non-service* partners, however, a rule that would permit a partnership to specially allocate gain to the service partner may encourage affected partnerships to disproportionately distribute ordinary income assets. But existing rules governing the distribution of "hot assets" under § 751 of the Code, perhaps extended to include assets that would generate short-term capital gain, should provide adequate safeguards against abuse. See IRC § 751(b)(1)(A).

[152] See IRC §734(b)(1)(A).

for $5,400 (9x$600), it will recognize the remaining $2,400 of gain ($5,400 - ($2,700+$300), allocating the entire amount to the limited partners.

The Bill could have adopted the second alternative. Under the second alternative, neither X nor GP would recognize gain.[153] Instead, GP would hold the distributed share as a "hot asset" to the extent of the deferred gain. Because GP's basis in the distributed share in this example is zero (i.e., GP's outside basis in X immediately before the distribution), the full $600 value of the distributed share would constitute hot asset gain in its hands.[154] In a later sale, therefore, GP would report the first $600 of gain as service income and any additional gain as long-term capital gain. Moreover, X would increase its basis in the 9 retained shares by $300,[155] assuming a valid § 754 election.

Finally, the Bill could also have adopted the third alternative. Under the third alternative, GP would again recognize $600 of ordinary compensation income, consisting of its $60 allocable share of the gain on the deemed sale of the distributed property (20% of $300) and $540 of gain on the deemed sale of its carried interest ($600-$60). Under this approach, however, the limited partners of X would also recognize $240 of gain (80% of $300), even though they did not participate in the distribution. Although taxing the non-service partners on the deemed sale conflicts with the general approach of the Bill, the pro rata allocation of gain is certainly more consistent with the "substantiality" requirement of § 704(b). Moreover, the limited partners would ultimately benefit from a

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[153] See IRC § 731(b).

[154] See IRC § 732(b).

[155] See IRC § 734(b)(1)(B) (excess of adjusted basis to X ($300) over basis to GP ($0)).

$240 "step-up" in the basis of the 9 retained shares, again assuming a valid § 754 election.

Finally, the Bill should clarify that the "invested capital" exception applies not only for purposes of apportioning both allocations of income and loss at the partnership level and gain to the holder on sale of an ISPI between service and non-service income, but to establish the percentage of the distributed asset to which the non-recognition rules of § 731(b) will continue to apply.[156] If, for example, a service provider with 25% of the invested capital and a 50% profits interest receives an in-kind distribution, the override of § 731(b) should apply only to 50% of the distributed property.

7. Dispositions of ISPIs

Under the Bill, gain on the disposition of an ISPI is treated as ordinary income from the performance of services.[157] A loss on the disposition of an ISPI is also treated as ordinary, but only to the extent of the excess of the aggregate net income over loss previously allocable to the service provider during the current and all preceding taxable years.[158] Current law will continue to govern any loss in excess of such amounts. The foregoing rules do not apply, however, to the extent of any gain or loss attributable to invested capital.[159]

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[156] Although it is possible to interpret the Bill differently, Section 710(c)(2)(B) does not reduce the percentage of gain recognized under Section 710(b)(4) in the in-kind distribution to reflect the invested capital of the service provider at the time of the distribution.

[157] Section 710(b)(1).

[158] Section 710(b)(2)

[159] Section 710(c)(2)(B).

The treatment of gain on the disposition of an ISPI as ordinary is similar to the treatment of gain on the disposition of a non-qualified stock option or of substantially unvested property received for services under current law.[160] The Bill has the virtue, therefore, of taxing an economically similar interest in a similar manner. This rule is also essential to the basic integrity of statute, serving as an adjunct to the rules governing allocations of service income. A service provider who receives a profits interest and values it at liquidation value (under what amounts to an "open transaction" approach) should not be permitted to avoid compensation income in respect of the interest (including the excess of its fair market value over liquidation value) by disposing of it and claiming capital gain.[161]

A disposition of an ISPI, however, may occur in contexts other than a fully taxable sale for cash to an unrelated third party. An ISPI may be transferred to an affiliate, a related party or to one or more family members or trusts in connection with estate tax planning. Alternatively, the service provider may transfer the ISPI to a transferee for non-cash consideration in a tax-free transaction. The service provider may also transfer the ISPI by gift or at death.

A service provider may seek to dispose of an ISPI in a non-arm's length transaction to a related party or in a non-recognition transaction, in either case as part of an effort to terminate the ISPI status of the interest and to limit the amount of income

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[160] Regs. § 1.83-1(b) and -7(a).

[161] If the service provider had instead formed a management company and entered into a long term management agreement with a fund, however, the service provider could potentially sell the management company in the future and report the gain as capital gain, even though an equivalent sale of an ISPI would generate ordinary income.

subject to recharacterization as compensation.[162] While the application of the Bill in the context of a sale for cash to an unrelated party seems both clear and appropriate, its application in other cases is less clear.[163] We therefore recommend that the Bill grant broad regulatory authority to address how the Bill should apply in the context of a disposition of an ISPI in the following cases:

- non-arm's length dispositions of an ISPI (including dispositions to related parties and transfers by gift or at death); and
- arm's length dispositions of an ISPI in transactions that otherwise qualify, either in whole or in part, for non-recognition treatment under applicable provisions of the Code;

(a) Non-Arm's Length Transactions

Transfers to related parties or to persons controlled by the service provider are prone to valuation abuse, as well as to premature termination of ISPI status. For example, it would seem inconsistent with the intent of the Bill, in particular given the potential for undervaluation,[164] to permit a service provider to sell a newly-issued ISPI that qualifies as a profits interest in a taxable transaction to a wholly-owned entity for cash equal to its purported fair market value, thereby "closing" the service element. Similar issues arise if the transferee is a relative of the service provider.

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[162] A transferred interest will not be an ISPI in the hands of a transferee unless the transferee unless also provides, directly or indirectly, a substantial quantity of specified services to the partnership. See Section 710(c).

[163] As in the case of disposition of unvested property or nonqualified options, a fully taxable sale of an ISPI to a person who is not a service provider or a related party should "close" the service element. Not entirely clear, however, is precisely what should qualify as an arm's length sale for this purpose. Note that the regulations specifically carve out a transaction with a related party from the rule otherwise applicable to the arm's length disposition of an option, even though § 83 provides no equivalent carve out for dispositions of unvested property. See Regs. § 1.83-7(a).

[164] For a more complete discussion of the problem of valuation in this context, see section V.A.2(c) of this Report.

One approach to address the problem of non-arm's length dispositions is to apply an "open transaction" or assignment of income approach to the transfer in accordance with the principles of Regulations § 1.83-1(c), which apply to transfers of substantially unvested property. Under the § 83 regulations, if a service provider transfers substantially unvested property in a non-arm's length transaction, the transferor will realize both (i) current compensation income at the time of transfer equal to the value of the consideration received for the interest; and (ii) future compensation income with respect to the property until it vests (treating any amount paid by the transferee to the transferor as an amount paid by the transferor for the property). The service provider will therefore recognize additional compensation income upon future vesting even though the service provider no longer owns the property. A similar rule appears to apply to a non-arm's length transfer of a nonqualified option, except that in the case of an option, vesting is not a taxable event; the future income is instead attributed to the service provider until the transferee exercises or disposes of the option.[165] In view of the economic similarity between an option and a profits interests, future regulations under the Bill might consider a similar approach.[166] We note, however, that the application of assignment of income and open transaction principles in this context is not necessarily

[165] See Regs. § 1.83-7(a).

[166] If Treasury adopts this approach, it should consider whether and to what extent the approach should apply to all future income allocable to the ISPI after the date of transfer, given the general exception for invested capital. The transferee should receive invested capital credit for any amount paid for the interest, even if the transferee is a relative.

parallel. If this approach is adopted, future regulations may opt to modify the § 83 definition of a "related party".[167]

Another possible alternative is to treat the interest as an ISPI in the hands of the transferee, even if the transferee does not provide direct or indirect services to the partnership. This approach, however, presents a number of issues, including the extent to which the transferee should receive invested capital credit for amounts paid for the interest (and, as discussed earlier in this Report, the application of the reasonable allocation requirement),[168] as well as transfers to tax indifferent transferees.

The regulations must also address the consequences of a transfer of an ISPI by gift or at death. Both raise valuation and assignment of income issues. The fair market value of the ISPI will generally have to be established at the time of the gift (for charitable deduction or gift tax purposes). Under the § 83 regulations, a transfer of an option by gift to a related party is presumably subject to the non-arm's length transfer rules described above. If Congress adopts either of the foregoing approaches to a non-arm's length transfer of an ISPI, it should adopt the same approach for gifts. In the case of a transfer at death, we note that the § 83 regulations treat income realized after death with respect to unvested property as "income in respect of a decedent" to which the rules of § 691 of the Code apply.

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[167] A person is "related" to the service provider if (i) the person is related within the meaning of §§ 267(b) or 707(b)(1), except that 20% is substituted for 50% and the definition of "family" is modified in certain respects; or (ii) the persons are engaged in businesses under common control within the meaning of § 52(a) or (b). See Regs. § 1.83-7(a)(1) and (2).

[168] See generally section V.A.2. of this Report. For example, a sale by a service provider of a profits interest to a related party for fair market value raises the same "reasonable" allocation issues that arise upon a purchase of a profits interest for fair market value by the service provider.

(b) Arm's Length Non-Recognition Transactions

A disposition of an ISPI in a transaction that would otherwise qualify as tax-free, either in whole or in part, also raises special issues. Most fundamentally, when if ever should the Bill tax the disposition? In the one non-recognition transaction that the Bill speaks to -- a § 731 distribution of appreciated property -- Congress chose to override non-recognition treatment.[169] In particular, when a partnership distributes property other than cash to the holder of an ISPI in exchange for all or a portion of an ISPI, the Bill requires the partnership to recognize gain, allocate the gain to the service provider, and then treat the service provider as if it had received cash equal to the fair market value of the distributed property.[170] The service provider therefore incurs immediate tax even though it may only have received illiquid property in the exchange. The threshold issue, therefore, is whether any other type of arm's length, but tax-free disposition of an ISPI should be eligible for non-recognition treatment. If so, how should the Bill ultimately tax the deferred gain?

One approach is to require immediate gain recognition (i.e., deny non-recognition treatment) in all cases. This approach will place a heavy burden on service providers in many exchanges, forcing them to recognize income upon the receipt of illiquid property. Moreover, a § 731 distribution of property to a service provider is more likely to occur in the context an arm's length valuation by adverse parties than in the context of many other types of non-recognition transfers, in particular those that do not involve either the

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[169] For a more complete discussion of the treatment of in-kind distributions, see section V.A.6. of this Report.

[170] See Section 710(b)(4)(A) and (B).

issuing partnership or its non-service partners. An alternative is to grant non-recognition treatment, but require the service provider to treat the property received in exchange as a "substitute" ISPI or as a disqualified interest.[171] If the transferee in the non-recognition transaction is a related party, the related party rules discussed above would also apply.

> *Example 15:* GP, otherwise unrelated to Newco, transfers his ISPI to Newco as part of a § 351 transaction, in exchange for 10% of Newco's common stock. At the time of the contribution, the ISPI is valued at $2 million.

Requiring the service provider to recognize ordinary income under these conditions would impose a heavy burden, triggering $2 million of taxable income even though the service provider receives no cash. Furthermore, the approach presupposes a proper valuation of the property received by the service provider. Rather than requiring the service provider to recognize gain, we recommend the approach described in the preceding paragraph. The service provider would therefore treat any future income attributable to the exchange property, whether in the form of dividends, gain on sale or otherwise, as compensation income.[172] Note that unless the transferee itself provides services to the partnership, the transferred ISPI would not be subject to the Bill in its hands.[173]

8. The Definition of "ISPI"

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[171] For example, such a rule might further provide that the service provider receives no "invested capital" credit for the value of any ISPI transferred in exchange for a disqualified interest except to the extent of any invested capital attributable to the transferred interest at the time of transfer or to the extent that the service provider actually recognizes a taxable gain.

[172] We note, however, that the grant of tax-free rollover treatment in this context will allow the service provider to diversify its future compensation income on a pre-tax basis, which is difficult to achieve under either § 83 or § 409A.

[173] Section 710(c) (definition of ISPI).

The Bill applies only to ISPIs.[174] Section 710(c)(1) defines an ISPI as any interest in a partnership if the partner owning such interest provides (directly or indirectly) a "substantial quantity" of certain designated services with respect to "specified assets"[175] of the partnership "in the conduct of the trade or business of providing such services".[176] The relevant services are:

- advising on the purchase or sale of such assets;
- managing, acquiring or disposing of such assets;
- arranging financing with respect to such assets; or
- supporting any activity related to these services.[177]

The definition of an ISPI presents several interpretive issues.

(a) Textual Ambiguities

Chief among the textual ambiguities is the concept of "substantial quantity". Although the phrase does not appear elsewhere in the Code or Regulations,[178] it may mean anything more than a *de minimis* amount of such services.[179] Also unclear is whether the term "substantial" is intended to capture the volume of designated services in

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[174] Section 710(a).

[175] A "specified asset" includes stock, debt, notional principal contracts, real estate, commodities, options and various derivative contracts. See Section 710(c)(1) (flush language).

[176] Section 710(c)(1).

[177] See Section 710(c)(1)(A) through (D).

[178] See Abrams at p. 965. Before its amendment in 1984, § 341(b)(1)(A) used the term "substantial part". When Congress amended § 341(b)(1)(A) in 1984, it replaced "substantial part" with the fraction "⅔". See Deficit Reduction Act of 1984 § 65(a), Pub. L. No. 98-369, 98 Stat. 494, 584 (1984).

[179] Id.

absolute terms or relative to any other services from the same partner.[180] Any attempt to quantify services by "amount" will be a difficult exercise.[181] Moreover, the Bill does not indicate the period of time over which the "substantial quantity" of such services must occur.[182]

The definition is ambiguous in other respects as well. First, Section 710(c)(1) speaks of a partner providing services "in the conduct of the trade or business of providing such services". It is not entirely clear whose trade or business is relevant to this analysis: the partner's or the underlying partnership's?[183] Although the drafters almost certainly intended the trade or business of the holder of the ISPI,[184] the Bill should clarify this point to avoid unnecessary confusion. Second, Section 710(c)(1)(D) also

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[180] Id.

[181] ABA Section of Taxation, "Comments on H.R. 2834" (Nov. 13, 2007), at p. 9 (hereinafter cited as "ABA Section of Taxation").

[182] See id. at 10; Schler at p. 829.

[183] See Abrams at p. 965.

[184] Providing investment management services to another is a trade or business. To the owner of the managed investments, however, the investment activities do not constitute a trade or business. As such, many of the funds targeted by the Bill do not engage in a "trade or business" at all. We assume, therefore, that Congress intended to refer to the trade or business of the service partner. See, e.g., Higgins v. Comm'r, 312 U.S. 212 (1941) (wealthy U.S. citizen residing permanently in Paris with office in New York that participated in certain real estate, stock and bond investments based on directions from Paris characterized as investor); Liang v. Comm'r, 23 T.C. 1040 (1955) (treating capital gains derived by foreign taxpayer from stocks and bonds as exempt from U.S. tax because activities of U.S. agent did not constitute trade or business); Cont'l Trading, Inc. v. Comm'r, 265 F.2d 40 (9th Cir. 1959) ("... since [*Higgins*] it is fair to say that it is settled law that the mere management of investments and the collection of rents, interests, and dividends is insufficient to constitute the carrying on of a trade or business ..."). In the case of a partnership, the IRS makes the trade or business determination at the entity-level. See IRC § 702; see also Brannen v. Comm'r, 78 T.C. 471, aff'd. 722 F.2d 695 (11th Cir. 1984) (because partnership is separate entity, character of deductions under § 162 resolved at partnership level); see also IRS Coordinated Issue Paper All Industries, Notional Principal Contracts, UIL NO: 9300.20-00 (Jan. 6, 2005); CCA 2002-38-002 (Apr. 25, 2002) (where non-dealer partnership engaged in transactions in securities and various derivatives, trade or business determination made at partnership level); FSA 200111001 (citing Higgins, Groetzinger, Moller and Liang in assessing whether partnership qualified as trader or investor).

includes the service of "supporting any activity" related to the enumerated services. It is difficult to know how broadly the drafters intended this provision to apply. For example, did the drafters intend to cover administrative or ministerial services performed by a partner who does not otherwise perform any of the enumerated services listed in Section 710(c)(1)(A), (B) and (C)? If so, the Bill should clarify this point.

Another textual ambiguity concerns the concept of an "interest in a partnership". Does an interest in a partnership include partnership debt or partnership options? What about a swap or other derivative involving a partnership interest? Given the Bill's treatment of "disqualified interests", this ambiguity is especially glaring. The Bill defines a "disqualified interest" to include any debt or equity interest in most entities, as well as options and any derivative interests with respect to such debt or equity, but excludes an "interest in a partnership".[185] It would create a statutory hole not to include debt, options and derivatives within the definition of an ISPI.

A final ambiguity is the definition of "specified assets". Recall that the term is important because in order for a partnership interest to be an ISPI, the partner must perform a "substantial quantity" of services with respect to such assets. Section 710(c) defines the term "specified asset" to mean "securities (as defined in section 475(c)(2) without regard to the last sentence thereof),[186] real estate, commodities (as defined in

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[185] See section V.A.11. of this Report.

[186] The last sentence of § 475(c)(2) provides that a security does not include any contract to which § 1256(a) applies. By defining a security to include those defined in § 475(c)(2) without regard to the last sentence, the Bill includes financial instruments that would otherwise qualify as securities even if § 1256(a) applies to them.

section 475(e)(2))), or options or derivative contracts with respect to securities (as so defined), real estate, or commodities (as so defined)."

§ 475(c)(2) defines securities to include shares of stock in a corporation, partnership or beneficial ownership interests in a widely or publicly-traded partnership or trust, evidences of indebtedness, interest rate, currency, or "equity notional principal contracts," derivative financial instruments in other securities and currencies, and certain identified hedges of other securities. This definition of securities, however, is underinclusive in important ways. Perhaps most critically, § 475(c)(2) treats only partnership interests in widely-held or publicly-traded partnerships or trusts as securities. Therefore, a carried interest in a "fund of funds" (i.e., a partnership that holds only closely-held partnership interests) would not be an ISPI under the Bill.[187] As a policy matter, however, it is not clear why such an interest should avoid characterization as an ISPI; the mere fact that the underlying investments are partnership interests (and not, for example, stock in corporate portfolio companies) should not materially alter the character of any gain in a future sale.[188] It may be appropriate, therefore, to expand the definition of specified assets to include a closely-held partnership interest. Alternatively, to avoid inadvertently subjecting a tiered operating partnership to the Bill, a "look through" rule

[187] If the particular fund of funds invests in the fund manager of other funds, however, the underlying investments may themselves constitute ISPIs. Under § 702, therefore, the character of the income as compensation should pass through, regardless of whether the fund of funds provides services and regardless of whether an interest in the general partner of the fund of funds is itself an ISPI. For a more complete discussion of the application of the Bill to tiered-partnership structures, see section V.A.9. of this Report.

[188] But see IRC § 751.

might apply, treating the indirect ownership of stock or other specified assets through one or more intermediate partnerships as direct ownership.[189]

(b) Problems of Scope

Far more problematic than these textual ambiguities, however, are two fundamental questions of scope: Which partnerships is Congress pursuing? And which partners?

(i)Partnerships Targeted by Congress. On the first question, the legislative history is clear. The target of the Bill is the investment fund that issues a profits interest for services, in particular private equity funds, venture capital funds, LBO funds, hedge funds and real estate funds.[190] The draft of the proposed legislation, however, makes no attempt to differentiate between an investment partnership and an operating partnership. We recommend that Congress better differentiate the two by statute and exclude a true operating partnership from the Bill entirely.

As discussed above,[191] the IRS chose to ignore the service element associated with the grant of a profits interests in 1993. Operating partnerships in nearly every industry grant profits interests for services in the ordinary course of business on a recurring basis. If the Bill were to apply not only to partnerships primarily engaged in investment or real estate activity, but operating partnerships as well, it would alter the taxation of many longstanding commercial arrangements not described in the legislative

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[189] For a fuller discussion of whether a pure operating partnership is subject to the Bill, see section V.A.8(b) of this Report.

[190] H.R. Rep. No. 110-431, at 136–43 (2007).

[191] See section III.A. of this Report.

history, in most cases without any increase in tax revenues. Given the stated objective of the drafters to tax income arising primarily from investment management as compensation, consideration should be given to narrowing the statutory language to target the types of partnerships cited in the legislative history.

As currently drafted, the Bill may treat an interest in a partnership that owns "specified assets" as an ISPI regardless of the reason it holds the assets and regardless of the relative percentage of total assets that "specified assets" represent.[192] Congress should consider narrowing the definition of an ISPI to apply to issuing partnerships that own specified assets representing a substantial percentage of the partnership's total assets.[193]

Ample precedent for an asset-based definition certainly exists. The Code currently provides many examples of specific entities that share the essential attributes of many investment funds. For example, the § 704 regulations define a "securities partnership" by referring to "qualified financial assets that constitute at least 90 percent of the fair market value of the partnership's non-cash assets".[194] As another example, § 731(c)(3)(C)(i) defines an "investment partnership" as "any partnership which has never

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[192] See Abrams at p. 965.

[193] For this purpose, the "substantially all" ruling safe harbor for § 368 reorganizations offers one possible framework. See Rev. Proc 77-37, § 3.01, 1977-2 C.B. 568. In the alternative, perhaps the 1984 change to § 341 is instructive. See Deficit Reduction Act of 1984 § 65(a), Pub. L. No. 98-369, 98 Stat. 494, 584 (1984) (replacing phrase "substantial part" with "⅔").

[194] See Regs. § 1.704-3(e)(3)(iii)(B)(*2*)(*i*).

been engaged in a trade or business and substantially all of the assets (by value) of which have always consisted of" cash, stock, debt and other financial instruments.[195]

Under any framework, however, the required threshold of specified assets should be relatively high. If the Bill includes a sufficiently broad definition of "specified asset", even a threshold as high as 80-90% is likely to capture almost every private equity, hedge or real estate fund currently in the market. If a high threshold is adopted, however, it is likely that some fund managers will respond by altering the asset composition of their funds. Existing limitations on the generation of UBTI/ECI will tend to constrain some of these strategies. Even with such a constraint, however, the Bill must anticipate the likely consequence of a high threshold on taxpayer behavior. For example, a manager may attempt to "stuff" an otherwise ineligible partnership with non-specified assets, perhaps even specially allocating all or substantially all of the related income to one or more "accommodation" partners. Accordingly, the definition of "investment partnership," in particular one with a high specified asset threshold, should be accompanied by an anti-abuse rule that would permit Treasury to either (i) aggregate assets among related partnerships; or (ii) disaggregate assets within a single partnership, in each case as appropriate to address these concerns.[196]

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[195] See IRC § 731(c)(3)(C)(i).

[196] In drafting an asset-composition test, Congress should consider whether the Bill might also exclude smaller investment partnerships, for example those that hold no more than $5-10 million in investment assets. See Carried Interest, Part II: Hearing before the S. Finance Comm., 110th Cong. (2007) (statement of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School) ("[s]o while I favor changing the law here, I would urge the committee to consider applying the new rule only to the larger or even largest partnerships. My sense is that might be a good balance of equity and concern for compliance costs and still get the committee most, if not all -- most, excuse me, of the revenue and equity advantages that change would bring."). To limit this exception to truly small funds, an exclusion of this sort should permit the IRS to aggregate the assets of multiple partnerships under the common control of a related manager.

But even if the Bill applies only to partnerships with a high percentage of specified assets, it will inadvertently capture partnerships not in the business of buying and selling investments. For example, most of the assets of a true operating partnership represent assets used in a trade or business, not "specified assets". Assume, however, that an historic operating partnership makes a purely strategic acquisition of another operating business by acquiring stock. If the stock represents a high percentage of the total partnership assets, should the acquisition transform the operating partnership into an investment partnership? No: the target business is not a portfolio investment. As a non-financial buyer, the operating partnership acquired the target business for strategic reasons, not to "flip" it a few years down the road. It is this difference that is the hallmark of an investment partnership. To protect strategic acquisitions, therefore, a "look through" rule should apply in appropriate cases pursuant to which an operating partnership would be treated as owning a pro rata share of the subsidiary's assets.[197]

At the other extreme, a test that defines an investment partnership solely on the basis of asset composition may fail to capture certain partnerships that probably should be subject to the Bill. For example, many "true" investment funds acquire operating businesses in asset acquisitions, even if certain investors in the partnership are adverse to UBTI or ECI. In some of these funds, the manager may form an "alternative investment vehicle" ("AIV") as a parallel partnership consisting solely of taxable U.S. investors. As a stand-alone partnership, the AIV will own no stock, securities, or other specified assets.

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[197] See, e.g., § 1297(c) (applying a similar rule for 25% or more owned subsidiaries in determining whether a foreign corporation is a PFIC). See also Regs. § 1.351-1(b)(4) (applying look through rule for subsidiaries for purposes of determining transferee corporation is an "investment company" within the meaning of § 351(e)).

Should the Bill apply to such a partnership even though all of its assets are used in a trade or business? Clearly yes. What if the investment partnership does not employ AIVs but instead acquires direct or indirect interests in various operating businesses? Whether the Bill was intended to apply to such a partnership is unclear.

One of the features of the Bill (some might say flaws), therefore, is that it ignores the nature of the activities of the partnership, which may not depend upon asset composition at all. An investment partnership is a "financial buyer" that buys and sells assets as a "trader" or "investor" within a particular sector of the market. A partnership formed for the purpose of buying and selling assets pursuant to a common partnership or other agreement should probably be subject to the legislation. Extending the Bill to such a partnership, however, will raise even further definitional issues. For example, would a partnership whose purpose is to buy operating businesses, operate them for five to seven years, and then sell the business normally fall within this definition?

In addition to characterizing a partnership interest in a partnership that owns specified assets as an ISPI regardless of asset composition, the Bill does not confine its impact to income attributable to investment assets. It instead recharacterizes all income allocable to an ISPI as compensation, regardless of its source. For example, 100% of the income allocable to the holder of an ISPI may be recharacterized as ordinary service income even if the investment assets of the partnership represent only 1% of total assets. Moreover, even when investment assets comprise a larger proportion of total partnership

assets, a different result would obtain if two partnerships were used, one for investment assets and the other for operating assets.[198]

One possible solution is to limit the service characterization to income attributable to investment assets. The Bill might even consider a "threshold" mechanism pursuant to which income of the service provider would be recharacterized as compensation only to the extent of the partnership's relative percentage of specified assets. The problem with this approach, however, is the incremental complexity. As drafted, the Bill already requires a partnership to "subdivide" allocations of income to the same service partner between services and invested capital. Moreover, as described in section V.A.1(b) and (d) of this Report, we have also recommended that Congress revise the Bill to allow affected partnerships to adjust the "invested capital" balances of their partners over time to reflect allocations of income and distributions. Requiring such a partnership to establish yet another set of "sub-accounts" for investment income and operating income would introduce additional compliance burdens without really effectuating the basic policy objectives of the Bill. If Congress simply excludes true operating partnerships from the Bill, this additional complexity is unnecessary.

(ii)Partners Targeted by Congress. On the second question of scope -- what type of partners Congress is pursuing -- the legislative history is equally clear: service providers engaged in the asset management business who report their share of the income from the managed investments as capital gain.[199] The lower tax rate on capital gain,

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[198] See ABA Section of Taxation at p. 10; see also Schler at p.849.

[199] H.R. Rep. No. 110-431, at 136 (2007).

however, is available only to individuals and certain trusts.[200] The legislative history includes the following statements, all of which target the conversion of highly-taxed service income into lightly-taxed capital gain: "some type of service providers in the asset management business have been paying tax at capital gains rates on service income";[201] "income from a carried interest may take the form of long-term or short-term capital gain";[202] "for individuals generally, the top rate of tax on long-term capital gain is 15%, while the top income tax rate on ordinary labor income is 35%".[203]

Congressman Rangel, who was the principal sponsor of both the current Bill and its predecessor, cited the 15% rate on capital gain as the basis of the legislation, calling the capital gains preference for profits attributable to a carried interest in an investment partnership an "unfair and unwarranted benefit".[204] In a television interview shortly after he introduced the Bill, Congressman Rangel said --

> Let me put it another way...If you didn't call it carried interest, it should be said what job are you doing that other people are doing [sic] that is so special? Are you managing other people's money? The answer is yes. And when people do this -- and a lot of people do this, and they make a lot of money doing it -- do they get taxed? Yes. What is their rate of taxes? 35 percent...But this other group -- they form a partnership. They don't

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[200] See IRC § 1(h) ("net capital gain" eligible for 15% rate); IRC § 1222(11) (defining "net capital gain" as "the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year"). Long-term capital gain is gain from the sale of property held for more than one year. IRC § 1222(3).

[201] H.R. Rep. No. 110-431, at 136 (2007).

[202] Id.

[203] Id. If Congress were to repeal the current law cap on the OASDI component of FICA and SECA (which is $102,000 for 2008), the characterization of an allocation of income attributable to an ISPI as "wages" would increase the effective tax rate to the service provider well beyond the current spread between capital gains and ordinary income rates. See IRC §§ 1401, 3101, 3111.

[204] Richard E. Cohen, Rangel's Reach, THE NATIONAL JOURNAL, Nov. 3, 2007.

> invest their own money. They do the same thing that the other corporations are doing, but they have this unique explanation, and that is what they say is that they are not [remunerated] just in cash, that they have now become a part of the organization, and so their fee is now capital. And, of course, capital gains is 15 percent...It's unfair.[205]

A week earlier, Congressman Rangel made the same point during a Business Week interview:

> The controversy is not about accumulating capital and encouraging investment. It's that some people who manage these [private equity] funds are taxed at a much lower rate than others. Why? We had hearings, and we found that these people use a method that they call carried interest, so instead of getting paid ordinary salaries for what they do, they are saying that they get a percentage of the firm's capital [gains] which is taxed at 15%. If it's money just like the others are making, they should be paying 35%.[206]

Even the accompanying press release from the House Ways & Means Committee cited the rate differential as the basis for the proposal:

> H.R. 3996 contains provisions to change the tax treatment of "carried interest" for investment fund managers. Under the Committee-passed legislation, they will no longer receive a lower capital gains rate of 15% for what is essentially a management fee or payment for services. Partners and managers would continue to receive a lower rate of taxation on returns derived from money they have personally invested. The Committee began looking at this issue in the context of fairness and equity in the tax code and found no evidence to conclude that these partners or fund managers should receive preferential treatment for the same services provided by other corporate professionals doing the same jobs.[207]

Nevertheless, the statutory language generally ignores the particular tax status of the holder. Instead, it characterizes a partnership interest as an ISPI in the hands of any

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[205] The Charlie Rose Show: Interview with Charles Rangel (PBS television broadcast Nov. 24, 2007).

[206] Maria Bartiromo, Facetime: Charles Rangel: Chairman, House Ways & Means, BUSINESS WEEK, Nov. 19, 2007, at 27.

[207] Press Release, House Ways & Means Committee, Congress Must Pass Responsible Tax Relief For Middle Class Families (Nov. 8, 2007).

holder who performs a substantial quantity of the relevant services, regardless of whether the holder is eligible for the 15% rate on capital gains, is subject to full U.S. tax on all categories of income at the same rate, is exempt from U.S. tax on most categories of U.S. source capital gain,[208] or is a tax-exempt organization. We recognize that the broader sweep of the statute was in certain respects deliberate. The drafters clearly intended, for example, that a publicly-traded partnership ("PTP") not be permitted to treat income allocable to an ISPI as "qualifying income" under § 7704(c), even if the income qualified as such based upon its character at the partnership level. As such, a PTP otherwise entitled to relief under § 7704(c) may be taxable as a corporation if it acquires an ISPI.[209] Congress should nevertheless consider whether the Bill should target the taxpayers described in the legislative history with greater precision. We note that restricting the Bill to individuals and other taxpayers eligible to claim the lower tax rate on capital gain will also tend to mitigate many of the collateral consequences described in this Report associated with the broad definition of an ISPI.

In the case of a foreign person, the actual consequences of applying the Bill will depend upon the particular facts, and in certain cases will produce unanticipated and

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[208] IRC § 872(a)(1) (gross income of a nonresident alien individual, other than income that is effectively connected with the conduct of a trade or business within the United States, is limited to U.S. source income).

[209] See H.R. Rep. No. 728, 110th Cong., 2d Sess. at 25 (2008) ("the present law exception to corporate treatment for a publicly-traded partnership, 90% or more of whose gross income is qualifying income ... does not apply ... because net income from an [ISPI] is not qualifying income ..."). Under § 7704(c), a PTP is taxable as a corporation unless at least 90% or more if its gross income is "qualifying income" (e.g., rents, dividends, interest, capital gains). Under the Bill, effective for taxable years beginning after December 31, 2010, income allocable to an ISPI will no longer constitute qualifying income, subject to an exception if 50% or more of the interests of a PTP are held by a REIT. See Section 201(e)(5) (deferred effective date for PTPs).

counterintuitive results.[210] Under one interpretation of the Bill, for example, the recharacterization of capital gain as "ordinary income for the performance of services" would attract U.S. tax only if the foreign holder performed the relevant services within the United States.[211] Accordingly, a foreign person who performs services outside the United States on behalf of a real estate fund may be exempt from U.S. tax under the Bill even though the same foreign person would be subject to both net basis taxation in the U.S. on his or her allocable share of the "effectively connected" income of the fund and full gross basis taxation on any U.S. source FDAP income of the fund.[212] If a foreign individual does perform services in the United States and is otherwise subject to net basis taxation, it should be subject to the Bill to the same extent as a U.S. individual.[213] Given these complexities, Congress should consider whether a foreign person who does not

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[210] See section V.A.10. of this Report.

[211] See IRC § 861(a)(3). Even this is not entirely clear. Assume, for example, that a particular fund manager hires a multinational management team to provide services to the fund both within and without the United States. Should a foreign member of management who holds an ISPI but performs no services in the United States nevertheless report a portion of the service income as U.S. source because it is a "partner" for tax purposes under the Bill and because a portion of the service income realized by other members of the management team is U.S. source ECI?

[212] Indeed, the legislative history has already identified some of the unintended consequences of the Bill as applied to foreign persons. See H.R. Rep. No. 728, 110th Cong., 2d Sess. at 25-26 (2008) ("[i]t is not intended that the provision be utilized to effect a recharacterization as untaxed foreign source compensation income the amount of any otherwise taxable (or withholdable) U.S. source dividend, effectively connected income, U.S. real property gain, or similar income or of any otherwise taxable subpart F inclusion or passive foreign investment company inclusion").

[213] For a more complete discussion of some of the collateral consequences of applying the Bill to foreign persons, see section V.A.10. of this Report.

perform services in the U.S. and who is not subject to tax as a "resident alien"[214] should be subject to the Bill.[215]

In the case of a domestic 'C' corporation, the capital gains preference is not available. A domestic 'C' corporation is subject to tax at the same rate on ordinary income and capital gain. Accordingly, the policy justification for recharacterizing capital gain as ordinary income in the hands of a C corporation is not very compelling, even if the occasional corporate holder of an ISPI may have expiring capital loss carryforwards.

In the case of a tax-exempt entity, how the Bill should apply will depend upon a number of considerations. First, certain tax-exempt entities bear tax on UBTI at the same rate as individuals.[216] Such an entity may therefore be eligible for the 15% rate on capital gains and qualified dividend income. Second, although tax-exempt entities usually do not provide actual services to an investment fund, some invest in the general partner or other entity that does provide such services.

If a tax-exempt entity receives an ISPI for services, the income allocable to the ISPI (except to the extent attributable to invested capital) is likely to constitute UBTI.[217] As consideration for services, the income will be attributable to an "unrelated trade or business" of the tax-exempt entity that does not qualify for relief under § 512(b). The far

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[214] See IRC § 7701(b)(1)(A) (definition of "resident alien").

[215] Even if the Bill exempts a foreign corporation on these grounds, a U.S. individual service provider who owns stock or any other interest in the corporation would remain subject to tax under the "disqualified interest" provisions of the Bill. For a more complete discussion of these provisions, see section V.A.11. of this Report

[216] See IRC § 511(b) (charitable trusts, etc.); IRC § 1(e).

[217] This Report does not address whether the grant of a profits interest to a tax-exempt investor in exchange actual services would generate UBTI under current law.

more common case, however, will not involve an actual service relationship. The tax-exempt investor will instead acquire an interest in an upper-tier partnership ("UTP"), which in turn will hold an interest in and provide services to a lower-tier partnership ("LTP"). Because the interest in the LTP will be an ISPI, the tax-exempt investor's distributive share of the income will be treated as ordinary (subject to the application of the invested capital rules). The policy question is whether the tax-exempt investor should be excluded from the Bill under these circumstances and, if not, whether its distributive share of income should be characterized as UBTI.[218]

9. Tiered Partnership Arrangements

A partnership interest is an ISPI only if the holder provides a substantial quantity of certain specified services with respect to the assets of the partnership, either directly or indirectly.[219] The application of the Bill to tiered-partnership structures raises a number of conceptual issues. In particular, whether services are being provided *indirectly* with respect to the assets of a partnership if a partner at one level of a tiered structure provides services to a partnership at another level, but provides no direct services to the partnership in which he is actually a partner.

> *Example 16*: A has a interest in UTP, an upper-tier partnership, which holds an interest in LTP, a lower-tier partnership. Although A provides no services to UTP, it provides substantial investment management services to LTP.

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[218] See IRC § 512(c) (trade or business activities of partnerships imputed to tax-exempt partners of partnership). If a tax-exempt investor is subject to the Bill, future regulations should consider granting relief if the investor contributes significant capital to an investment partnership and, in consideration thereof, also receives an interest in the general partner. The usual purpose of these arrangements is to "buy down" the effective carry percentage that the tax-exempt investor would otherwise bear as an expense if it had invested its capital in the underlying fund on the same terms as the other investors.

[219] Section 710(c)(1).

Is A "indirectly" providing services to UTP within the meaning of the Bill? We believe it is, and that A's partnership interest in UTP should therefore constitute an ISPI.[220] In the absence of such a rule, a service provider could easily circumvent the purposes of the Bill.

> *Example 17*: A has an interest in LTP, a partnership. A provides no covered services to LTP, but does provide such services to UTP, a partnership which holds a partnership interest in LTP. Is A providing indirect services to LTP? Does it matter whether UTP also provides services to LTP?

In this example, A should not be treated as providing indirect services to LTP merely because A provides direct services to UTP. If UTP provides direct services to LTP, however, it may be appropriate to treat A as providing indirect services to LTP in certain cases. For example, if UTP were to contract with LTP to provide covered services, and UTP were to then retain the services of one or more of its partners to fulfill these contractual obligations, the partners should be treated as providing indirect services to LTP. Indeed, the carried interest in a typical investment fund is a "back-to-back" service arrangement of precisely this type: the partners of the general partner participate in the carried interest of the general partner by indirectly providing services to the underlying fund in their capacity as service providers to the general partner (or an affiliate):

> *Example 18*: LPs invest $900 in Fund, a newly-formed partnership. Upon formation, Fund grants a carried interest to GP for services. The members of GP each provide services to GP in support of the services GP provides

[220] The legislative history adopts a similar conclusion with respect to indirect services provided by a holder of a "disqualified interest". See section V.A.11. of this Report. The example in the legislative history concludes that services provided to an investment partnership by a shareholder of a Cayman corporation that holds a carried interest in the investment partnership constitute indirect services to the Cayman corporation. See H.R. Rep. No. 728, 110th Cong., 2d Sess. at 23-24 (2008).

to Fund. Although GP invests no capital in Fund, the members of GP invest $100 of capital in Fund for additional LP interests.

Note that the members of GP in this example invested capital in the Fund, not in the GP. Service providers to fund managers often invest their share of the total capital directly in the sponsored fund or through a "parallel vehicle". They may choose to do so for any number of non-tax reasons, among them to limit the assets of the general partner available to fund future creditor claims. In these situations, both the partnership interest in the general partner and the direct partnership interest in the fund should be treated as ISPIs.[221] Accordingly, the capital invested in Fund will constitute "invested capital" of the GP members, not capital that is exempt from the Bill.[222] If the capital were exempt, the members of the GP could allocate a disproportionate share of the profits to such capital and then reduce the carry percentage of the GP to circumvent the provisions of the Bill.

(a) Invested Capital in Tiered Structures

The application of the invested capital exception to tiered-partnership structures also raises issues concerning the reasonable allocation requirement and the corresponding application of the *per se* rule.[223] Investment partnerships and operating partnerships alike routinely deploy tiered-partnership structures for perfectly valid business reasons. The

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[221] Under the Bill, an ISPI is any partnership interest held by a person who "directly or indirectly" provides the enumerated services. See Section 710(c)(1). Accordingly, the Bill as drafted appears to treat both the carried interest granted to GP and the additional LP interests in Fund as ISPIs.

[222] Although other interpretations are possible, the Bill probably aggregates the invested capital in both entities for purposes of determining the portion of the total combined return on the two ISPIs that represents compensation for services.

[223] For a more complete discussion of the reasonable allocation requirement and the related presumption, see section V.A.2. of this Report.

invested capital exception should therefore apply to tiered-partnerships in a manner that neither penalizes the service provider nor provides an unwarranted benefit.

> *Example 19*: X is a newly-formed investment partnership. X issues 100 limited partnership units for $100 each. A, who does not provide services to X, acquires one limited partnership unit of X for $100. GP, a partnership, receives a 20% carried interest in X in exchange for services. A also invests $50 in GP (used to fund GP expenses) in exchange for the right to 5% of the future profits of GP but provides no services to GP.

In Example 19, the limited partnership unit in X should not constitute an ISPI because A is not providing any direct or indirect services to X. Thus, A's distributive share of any capital gains realized by X with respect to such unit should retain its character.

> *Example 20*: The facts are the same as in Example 18, except that A invests $100 in GP (rather than directly in X), which GP invests in X in exchange for one limited partner unit. A also receives 5% of the GP profits in exchange for services. X specially allocates all income attributable to the limited partner unit to A. Assume that this special allocation to A has "substantial economic effect" under § 704(b).

In this example, GP has $100 of invested capital in X. GP's distributive share of income with respect to its limited partner unit in X should therefore qualify for the invested capital exception. Moreover, because A is specially allocated all of GP's income with respect to such unit, the income should retain its character as it passes from X to GP and then from GP to A.

(b) Character Pass-Through

In both Example 18 and 19, the Bill will treat all income that GP derives with respect to its carried interest in X as compensation because the carried interest is an ISPI. Under § 702, the character of such income as compensation should pass through to the partners of GP, regardless of whether they provide services and regardless of whether

their partnership interests in GP constitute ISPIs. In both examples, therefore, A's 5% distributive share of GP profits attributable to GP's carried interest in X should constitute ordinary service income. Similarly, if GP sells its carried interest in X, the gain should constitute service income to both GP and its partners.

In both examples, therefore, A's distributive share of GP's income is ordinary because it is ordinary income in the hands of GP.[224] It appears, however, that none of the income will be subject to SECA tax. Under current law, a limited partner in a partnership is not subject to SECA tax with respect to its distributive share of partnership income except to the extent that the limited partner receives a guaranteed payment for services.[225] The conclusion that A is not subject to SECA tax appears to reflect an appropriate result.[226]

The result would be different if A itself was a service provider and A's interest in GP was an ISPI. In such a case, A would be subject to SECA tax on its distributive share of income derived from GP (other than income attributable to invested capital) under the general provisions of the Bill.[227] If A had been a general partner of GP, but did not provide any services, it appears that A would likewise be subject to SECA tax on such income.[228]

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[224] IRC § 702.

[225] IRC § 1402(a)(13).

[226] Nor would the SECA tax apply if GP had received the allocation as a fee for services. The SECA tax consequences to A should not differ because A received the fee as a partnership allocation.

[227] Section 710(d)(3).

[228] The income is treated as services income to GP and none of the exclusions from "net earnings from self employment" apply.

(c) Sale of an Interest in an Upper-Tier Partnership

Under § 751(a) of the Code, the amount of money or fair market value of property received by a transferor partner in exchange for all or part of his interest in a partnership that is deemed to be attributable to "unrealized receivables" or "inventory items" constitutes gain or loss from the sale of property other than a capital asset.[229] The Bill would treat an ISPI as an "inventory item" for this purpose.

Under this provision, therefore, if an upper-tier partnership ("UTP") holds an ISPI in a lower-tier partnership ("LTP") and a partner in the UTP sells its partnership interest, the selling partner will be required to realize ordinary income on the disposition to the extent that a sale *by* the UTP of the partnership interest in the LTP would have resulted in gain under § 751. This result obtains regardless of whether the interest in the UTP is itself an ISPI. Indeed, if the interest sold by the partner of the UTP were itself an ISPI, the gain on sale would constitute ordinary income under the Bill without regard to the treatment of the ISPI at the LTP level under § 751.[230] For the reasons discussed above, if the selling partner it not itself a service provider and the interest sold is not an ISPI, the ordinary income recognized as a result of this provision should generally not be subject to SECA tax.

> *Example 21*: A, an individual who is not a service provider, holds an interest in UTP, a partnership. Among other assets, UTP owns a

[229] Under Regs. § 1.751-1(a)(2), the portion of any income or loss realized by a partner upon a sale or exchange of its partnership interest that is deemed to be attributable to § 751 property is the amount of such income or loss (including any "remedial" allocations under Regs. § 1.704-3(d)) that the partnership would have allocated to the selling partner had the partnership sold all of its property in a fully taxable transaction immediately prior to the sale.

[230] Although even in that case, the result would be different if the net gain on the sale was less than the § 751 gain with respect to the ISPI.

partnership interest in LTP. Assume that the interest in LTP is an ISPI and that if UTP were to sell that interest at a gain, A's distributive share would be $10. If A sells his interest in UTP, A will recognize $10 of ordinary income under the Bill because the interest in LTP is a § 751 inventory item to UTP. The $10 of ordinary income recognized by A will not be subject to SECA tax under the Bill because A's interest in UTP is not itself an ISPI.

10. Source of Income from an ISPI

Because the Bill treats an allocation of income with respect to an ISPI as service compensation "for purposes of this title," the source rules governing services will apply to these allocations absent contrary guidance. In general, the Code sources service income to the place where the services are performed.[231] Accordingly, by characterizing a partnership allocation as compensatory, the Bill may alter the source of the underlying income. In the case of a foreign person, allowing the Bill to alter source potentially alters taxing jurisdiction as well, producing results that do not reflect the policy objectives of the Bill.

For example, suppose that a foreign partner provides services outside the United States to a partnership that does business both within and without the United States. Under current law, the foreign partner will be subject to U.S. tax on its allocable share of the effectively connected income of the partnership.[232] Because the foreign partner performed the services outside the U.S., however, the Bill may convert taxable income into tax-exempt income.[233]

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[231] IRC §§ 861(a)(3) and 862(a)(3).

[232] See IRC §§ 871(b), § 882.

[233] As described more fully in section V.A.8(b) of this Report, however, even this is not entirely clear. If other service partners of the partnership perform services in the U.S., an alternative interpretation of the Bill is that the foreign service provider, who would remain a "partner" for tax purposes under the Bill, must

Assume instead that a foreign partner provides services outside the United States to a partnership that does not do business in the United States, for example a hedge fund that relies upon the "trading" safe harbor under § 864(b) of the Code. Is the foreign partner still subject to U.S. withholding tax on its allocable share of domestic source dividend income, or does the Bill convert such income into exempt foreign source service income? If the latter, might a foreign investor in such a fund avoid FDAP withholding entirely by providing a modest amount of prohibited services to the fund and then investing its capital contribution with "disqualified" capital (e.g., by borrowing the money from another partner on a fully recourse basis)?[234]

The situation is similar for operating partnerships that do business in the U.S. or realize gain on the sale of U.S. real estate. Under current law, a foreign partner in such a partnership is taxable on its allocable share of the effectively connected income,[235] and may also be subject to the branch profits tax.[236] If the income is foreign source service income, however, the foreign partner may avoid U.S. taxing jurisdiction entirely. In the

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report an allocable portion of the aggregate service income as U.S. source. See H.R. Rep. No. 728, 110th Cong., 2d Sess. at 25-26 (2008) ("[i]t is not intended that the provision be utilized to effect a recharacterization as untaxed foreign source compensation income the amount of any otherwise taxable (or withholdable) U.S. source dividend, effectively connected income, U.S. real property gain, or similar income or of any otherwise taxable subpart F inclusion or passive foreign investment company inclusion").

[234] See Schler at p. 841 (noting that if a foreign GP of a U.S. real estate partnership provides services outside of the United States and makes a large capital investment with the proceeds of a fully recourse arm's length loan from another partner, "the entire allocation of income to GP would be foreign source compensation income exempt from U.S. tax").

[235] § 871(b) and § 882 impose U.S. tax at graduated rates on income that is "effectively connected" with a U.S. trade or business conducted by a non-U.S. individual or corporation; § 897(a) taxes gain and loss of a non-U.S. individual or corporation from the disposition of a "United States real property interest" as if such gain or loss were effectively connected with the conduct of a U.S. trade or business.

[236] IRC § 884 (if the foreign person is a corporation).

case of a foreign governmental entity, the partner may even avoid tax on commercial activity income (which is generally not exempt from U.S. tax).[237]

Indeed, if the Bill applies to a foreign person who does not provide services in the United States, it may allow a U.S. person not subject to the Bill to defer tax on income otherwise subject to immediate tax under the Code. Assume, for example, that a United States shareholder owns stock of a controlled foreign corporation ("CFC").[238] Assume further that the CFC invests "disqualified" capital in an investment partnership (e.g., the proceeds of a loan from another partner) and also agrees to provide an amount of prohibited services outside of the United States to the partnership that, although limited, is nevertheless sufficient to trigger application of the Bill.[239] Under current law, the foreign corporation's distributive share of investment income from the partnership is likely to constitute "foreign personal holding company income" under § 954(c) of the Code. As such, the U.S. shareholder will be subject to immediate tax under subpart F. If the Bill recharacterizes the income as service compensation to the CFC, however, the same shareholder may defer tax on the income until its ultimate repatriation.[240]

We do not believe that any source rule will effectively resolve these issues so long as the income itself retains its character as service income. If the source rule is that

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[237] IRC § 892.

[238] See IRC § 951(b) (definition of United States shareholder); IRC §957(a) (definition of controlled foreign corporation).

[239] The CFC must provide a "substantial quantity" of the prohibited services. See Section 710(c)(1)(A) through (D).

[240] For the same reason, the distributive share may also avoid characterization as "passive income" for purposes of determining whether the foreign corporation is a PFIC. See IRC § 1297(b) (treating most categories of "foreign personal holding company income" under § 954(c) as passive income for PFIC purposes).

income recharacterized as compensation under the Bill retains its source at the partnership level, it will only solve one set of problems by introducing another.[241] For example, "portfolio interest" paid by a U.S. corporation to a partnership not engaged in a U.S. trade or business and allocable to a foreign service provider would attract U.S. withholding tax on a gross basis.[242]

The legislative history recognizes many of the foregoing concerns and directs Treasury to provide guidance.[243] Although we assume that taxpayers may rely on this statement as self-implementing, an express provision in the statute to this effect would be helpful. Moreover, as discussed in section V.A.8(b) above, Congress should consider whether foreign persons who do not provide services in the United States should be subject to the Bill at all.[244] Alternatively, the Bill might apply to such persons, but respect both the source and character of the income at the partnership level.

Additional guidance will also necessary to harmonize the consequences of the Bill with the foreign tax credit. Assume, for example, that a domestic partner provides services in the United States to an entity treated as a partnership in a foreign jurisdiction in which it does business. The domestic partner is likely to be liable for tax in that

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[241] See Schler at p. 841 (makes same point).

[242] See IRC § 871(a).

[243] See H.R. Rep. No. 728, 110th Cong., 2d Sess. at 25-26 (2008) ("[i]t is not intended that the provision be utilized to effect a recharacterization as untaxed foreign-source compensation income the amount of any otherwise taxable (or withholdable) U.S.-source dividend, effectively connected income, U.S. real property gain, or similar income or of any otherwise taxable subpart F inclusion or passive foreign investment company inclusion.").

[244] See Schler at p. 843 ("section 710 should not apply to any partner that is a non-resident alien individual, foreign corporation, or foreign government, if that person performs services outside the United States").

jurisdiction on its distributive share of the partnership income. Under current law, the domestic partner would generally be entitled to claim a foreign tax credit.[245] A foreign tax credit is allowed, however, only for taxes paid on foreign source income.[246] If the Bill's characterization of a partner's income as compensation income also alters its source, the partner may be denied the credit.[247]

Even if the Bill respects the source of the income, the availability of a foreign tax credit may be limited. Under the "basket" limitations of § 904(d), foreign tax credits are applied separately to passive category income and general category income (including compensation income). If a foreign country taxes the income in accordance with its underlying character, the Bill's characterization of the income as compensation may disqualify it under the basket limitations. Denying the foreign tax credit in this context is unfair, and wholly unrelated to the Bill's policy goal of treating carried interest as compensation. Future guidance should clarify that the Bill does not alter the application of the foreign tax credit, either by changing the source of the income or the "basket" into which the income falls.[248]

Finally, guidance regarding source must distinguish between the source consequences governing the direct grant of an ISPI for services and the source

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[245] IRC §§ 901(a) and 901(b)(5); see also Schler at p. 841 (citing additional examples of problems associated with change in source).

[246] IRC § 904(a).

[247] See Schler at p. 841 ("even though section 710 treats the income of GP as compensation income, it should not change the source of GP's income for purposes of section 904").

[248] See Schler at p. 841 ("it would be most logical for the basket to be determined without regard to section 710").

consequences governing the grant of an interest in a partnership that itself holds an ISPI. A typical carried interest in an investment fund is a "back-to-back" service arrangement: the partners of the general partner participate in the carried interest of the fund by providing services to the general partner in exchange for an interest in the general partner. Accordingly, two distinct source rules may apply. Under one source rule, because the carried interest in the fund is an ISPI, the source of the resulting service income to the general partner should "pass through" to the partners of the general partner under § 702 of the Code.[249] Under another source rule, source should depend upon where the partner of the general partner provides the services[250] because the partner's interest in the general partner of the fund is itself an ISPI. In such a case, does the Bill source the service income of the partner in accordance with where the partner of the general partner provides services to the general partner or in accordance with where the general partner provides services to the investment partnership? For multinational partnerships, the source of each is likely to differ.

11. Disqualified Interest Provisions

(a) The Proposal

As presently drafted, the Bill will potentially apply not only to the grant of a partnership interest for services, but to the grant of an interest in certain types of non-partnership entities for services as well. According to the legislative history, the purpose

[249] See IRC § 702(b) (character determined "as if such item were realized directly from the source from which realized by the partnership ...") (emphasis added). Indeed the source and character of the income will pass through regardless of whether the partners actually provide services to the general partner. For a more complete discussion of the application of the Bill to tiered-partnership structures, see section V.A.9. of this Report.

[250] IRC §§ 861(a)(3) and 862(a)(3).

of these anti-abuse rules is to discourage the use of such entities to circumvent the policy objectives of the Bill.[251]

The Bill provides that if (i) a person performs (directly or indirectly) investment management services[252] for any entity, (ii) such person holds a "disqualified interest" with respect to such entity, and (iii) the value of the interest (or payments thereunder) is substantially related to the amount of income or gain (realized or unrealized) from the assets with respect to which the investment management services are performed, then any income or gain attributable to the interest shall be treated as ordinary income from the performance of services.[253]

In general, a disqualified interest includes any debt or equity interest in an entity, any option or other right to acquire an interest in such entity, and any derivative instruments entered into (directly or indirectly) with such entity or any investor in such entity. It does not include (i) non-convertible, non-contingent debt of the entity or any option to acquire such debt; (ii) stock of a domestic C corporation or foreign corporation subject to "comprehensive" foreign income tax"; or (iii) a partnership interest.[254] If the service provider has "invested capital" in a disqualified interest, then relief principles

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[251] H.R. Rep. No. 728, 110th Cong., 2d Sess. (2008).

[252] Investment management services means a substantial quantity of any of the services described in Section 710(c)(1) (i.e., covered services for purposes of determining whether a partnership interest is an ISPI), which are provided in the conduct of the trade or business of providing such services. Section 710(c)(2)(C).

[253] Section 710(d).

[254] Section 710(d)(2)(A) and (B). The Bill defines these entities as "taxable corporations."

similar to those governing a service provider with invested capital in an ISPI will apply.[255]

Finally, the Bill would amend § 6662(b) (the "substantial understatement" penalty) to include understatements attributable to Section 710(d). For this purpose, the Bill increases the penalty rate under § 6662 to 40%, with no exception for understatements otherwise eligible for relief under the "reasonable cause" exception of § 6664.

The legislative history illustrates the application of these provisions in the context of a hedge fund manager (the "Cayman Example").[256] In the example, a manager of a hedge fund holds stock in a Cayman corporation that in turn holds a partnership interest in the hedge fund. The example assumes that either the value of the stock or the amount of the dividends paid on the stock is "substantially related" to the growth and income of the hedge fund assets. Because the manager provided investment management services to the hedge fund, the manager was deemed to provide such services to the Cayman corporation. The Cayman Example therefore characterizes the stock as a disqualified interest, treating any dividends or gain on sale as taxable compensation.

(b) Technical Comments

First, it is important to emphasize that the basic architecture for taxing the service element of a disqualified interest is already in place under current law. Using "liquidation value" as a proxy for fair market value is permissible only in the case of a

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[255] Section 710(d)(1).

[256] H.R. Rep. No. 728, 110th Cong., 2d Sess. at 24 (2008).

partnership interest issued for services.[257] Although every class of interest included within the definition of a "disqualified interest" under the Bill is "property" for tax purposes (other than an option), a disqualified interest does not include a partnership interest.[258] We have assumed, therefore, that the drafters of the Bill concluded that § 83 afforded an inadequate mechanism for taxing the service element in this context, based perhaps upon the expectation that service providers will routinely "low ball" the valuation of the interest upon grant.

The Bill recharacterizes income or gain from a disqualified interest as compensatory, but not loss. This differs from the treatment of losses arising from an ISPI. In the Cayman Example, if the manager had received dividend distributions taxable as compensation and then realized a later loss on a sale of the shares, the loss would have been capital, not ordinary. Had the manager instead acquired a direct interest in the underlying hedge fund, the same economic loss would have been ordinary under the general rules governing ISPIs. Depending upon how the invested capital exception applies to a disqualified interest, this may or may not be an appropriate result.

The Bill also excludes "stock" of a taxable corporation from the definition of disqualified interest, but does not exclude interests other than stock in the same corporation (other than those interests generally excluded from the definition of a disqualified interest). Convertible debt of a taxable corporation, for example, is a

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[257] Rev. Proc. 93-27, 1993-2 C.B. 343.

[258] Section 710(d)(2)(A)) ("such term does not include a partnership interest ...").

disqualified interest. So is a stock option.[259] Given the compensatory treatment of options under current law, it is unclear whether this was intended. Moreover, although the legislative history does not explain the rationale for excluding stock in a taxable corporation, the drafters probably decided that the loss of a valuable compensation deduction to a fully-taxable service recipient established sufficient adversity of interests to discourage low valuations.[260] That same reasoning, however, would extend to a non-stock interest in a taxable corporation.[261]

Although certainly appropriate in principle, importing the invested capital exception into the disqualified interest regime will raise all of the complex issues previously discussed in the context of an ISPI, for example the amount of invested capital to credit a purchaser of a disqualified interest and how to establish a "reasonable" allocation of income between invested capital and services. In addition, with no analogue to the special treatment of a profit interest under subchapter K, it is not at all clear how the Bill would apply the invested capital exception to a disqualified interest.[262]

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[259] While § 83 already treats income attributable to a non-qualified option issued for services as compensation, the Bill appears to extend compensatory treatment to income attributable to an investment option (e.g. an exchange-traded option), subject to whatever relief may be available under the invested capital exception. It is even possible that an incentive stock option is a disqualified interest.

[260] For example, if a service provider receives stock of a domestic C corporation for services and reports the receipt of the stock at a low valuation, the corporation will claim an equally low compensation deduction.

[261] Assuming at least that the grantor of the interest is either the corporation or a shareholder, in which case the corporation may generally claim a compensation deduction under Regs. § 1.83-6.

[262] Among other things, the potential for double taxation at compensatory rates is greater in the case of a disqualified interest. In the Cayman Example, if the manager were to receive shares in the corporation for services and if the corporation were to hold a profits interest in the underlying fund as its sole asset, the manager would nevertheless realize compensation income upon receipt of the shares. Unlike the case of an ISPI, a manager cannot avoid immediate income by electing to value stock at liquidation value.

A share of stock in an S corporation is a disqualified interest. If a service provider acquires shares of an S corporation while the S corporation holds appreciated assets, the service provider will have compensation income not only when the service provider sells the shares, but when the S corporation recognizes the built-in gain. Unlike the issuer of an ISPI, an S corporation cannot make a § 754 election to "step up" the inside basis of its assets for the benefit of the purchasing shareholder. Although this is an inherent feature of subchapter S, granting invested capital relief in this context will at least eliminate double taxation of the service element, provided that Congress expands the scope of this exception in accordance with our recommendations in section V.A.2. of this Report.[263]

As in the case of an ISPI, the proper treatment of a tax-free disposition of a disqualified interest will also have to be addressed. In some cases, for example in the case of convertible debt, this issue will be encountered less frequently in the partnership context, but will arise much more frequently with other types of entities.

The increased strict liability under § 6662 penalty for substantial understatements relating to a disqualified interest seem inappropriate given the difficult interpretive and valuation issues presented. Consideration should be given to softening these penalties or establishing a reasonable cause exception.

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[263] For example, assume that B purchases 10% of the stock of an S corporation from A for $120, that S has no debt, and that S holds appreciated assets. Even if all of B's income from S is attributable to invested capital, B will be taxed in the future on the built-in gain already recognized by A as an economic matter in the prior sale. If B receives no invested capital credit because he did not actually contribute capital to S or because B inherited only A's invested capital, however, that gain will be taxable as service income as well.

Future regulations should also clarify the meaning of "indirect services." The Cayman Example[264] establishes the principle that indirect services are provided to a corporate issuer of a disqualified interest if the corporation is a partner in a partnership and a shareholder of the corporation provides such services to the partnership. Would the shareholder also be deemed to provide indirect services if the shareholder provided the services to a taxable corporate subsidiary of the foreign corporation?

As described in section V.A.1(c) of this Report, we have recommended that the grantee of an ISPI receive invested capital credit for the amount includible in income upon grant under § 83, but not in excess of its liquidation value. Subject to relief under the invested capital exception, therefore, the grantee would remain subject to the Bill. Whether or not Congress adopts this recommendation, however, Congress should consider exempting the grantee of a disqualified interest entirely. The grantee of a disqualified interest will not benefit from the special valuation rules available to partnership interests and will therefore bear tax on the full service element under the principles of § 83. If Congress is concerned that the grantee will undervalue the disqualified interest, it should consider increasing the penalty rate for undervaluations.[265]

B. Anti-Fee Deferral Bill

1. The Context

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[264] We note that the Cayman entity in the example is a PFIC for tax purposes. The manager, therefore, will not benefit from deferral and, unless it makes a valid QEF election under § 1295, will bear tax at ordinary income rates on most or all of the future gain. Moreover, whether or not the manager makes a valid QEF election, the dividends from the Cayman corporation will not qualify for the current 15% rate. See IRC §1(h)(11(C)(iii) (PFIC is not a "qualified foreign corporation"). Finally, the service provider will bear tax on the PFIC shares upon grant or vesting at full fair market value. IRC § 83.

[265] For a more complete discussion of the problem of valuation in the fund context, see section V.A.2(c) of this Report.

In certain funds, the manager will structure the carry not as a profits interest in a partnership, but as a fee for services. Under current law, this alternative produces fundamentally different tax consequences, not only to the manager but to the taxable investors in the fund. Although managers in private equity and real estate funds rarely structure the carry as a fee for services, the manager of a hedge fund may. One reason is that many hedge funds generate very little long-term capital gain. By pursuing investment strategies that involve shorter holding periods or that otherwise generate ordinary income, the manager and individual members of such funds will often bear effective tax rates on the carry that approximate the effective tax rate on service income.[266]

Even in such a fund, however, the manager will tend to structure the carry as a partnership allocation if the fund has taxable investors. The reason is that a taxable investor, whether individual or corporate, will prefer to bear the carry expense as a partnership allocation regardless of the character of the underlying income. If structured as a fee, the carry will generate "investment expense" under § 212 to an individual investor unless the fund qualifies as a "trader" rather than an "investor."[267] Moreover, if the fund defers payment of the carry, the investors will bear immediate tax on the portfolio gains earmarked for future payment to the manager. A direct allocation of

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[266] Because hedge funds generate investment income, however, the manager will still avoid self-employment taxes, provided that it structures the carry as a partnership allocation and not as a fee. See §§ 1402(a)(2) ("net earnings from self-employment" excludes dividends and interest), 1402(a)(3)(A) ("net earnings from self-employment" excludes gain from sale of capital asset).

[267] Most hedge funds contend that they qualify as traders. But see Rev. Rul. 2008-39, 2008-31 IRB 252 (ruling that management fees paid by upper-tier fund that did nothing but hold interests in lower-tier fund was a § 212 expense even though lower-tier fund qualified as a trader).

income to the manager, on the other hand, will usually convey the economic equivalent of a deduction to the taxable investors.

Tax-exempt and foreign investors, however, are generally exempt from net basis taxation on their hedge fund returns.[268] As such, they do not derive any tax benefit from the investment expenses of the fund, including the carry. For these particular investors, therefore, the decision of the manager to structure the carry as a fee will not reduce their after-tax returns. In many hedge funds, the manager will structure the carry attributable to the "tax indifferent" capital of the fund as a fee for services, deferring receipt of all or a portion of the fee until a future period.[269] Any amount so deferred will remain invested in the fund, usually participating on a pre-tax basis in the future portfolio gains.

2. Current Law

When a service provider defers the receipt of compensation, the service provider defers tax at the cost of deferring a corresponding deduction to the service recipient. In general, § 404(b) of the Code postpones the deduction whether or not the service recipient reports income on the accrual method of accounting by forcing the service recipient onto the cash method with respect to the compensation deduction. The resulting tax "tension" between the service provider and the service recipient therefore tends to

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[268] IRC § 864(b).

[269] An effective fee deferral also requires a manager to report income on the "cash method" of accounting. Under the cash method of accounting, a taxpayer must report gross income upon actual or constructive receipt, even if the right to such income becomes fixed and determinable on an earlier date. See Regs. § 1.446-1(c)(1)(i). A manager on the cash method of accounting may therefore defer a fee beyond the taxable year of service *if* the deferral meets certain conditions, include the requirements of § 409A of the Code. A taxpayer may choose any method of accounting prescribed by the Code or regulations so long as that method clearly reflects income. See IRC §§ 446(a) (exclusions), 446(b) (exceptions to exclusions) § 448, however, prohibits reporting on the cash method by most C corporations, by most partnerships with a C corporation partner, and by any "tax shelter".

constrain purely tax-motivated deferrals. When the service recipient is exempt from U.S. tax, however, this natural tension is no longer present. Although the service provider will still derive a tax benefit from the deferral, the service recipient will suffer no countervailing tax detriment.[270]

3. The Legislative Proposal

It is against this backdrop that Congress proposed new Section 457A.[271] Although § 409A of the Code already regulates fee deferrals by hedge fund managers, § 409A limits rather than prohibits deferrals, and applies without regard to whether the service recipient derives a tax benefit from earlier payment of the accrued compensation expense. New proposed Section 457A may fairly be characterized as equating a foreign investor in a hedge fund with a tax-exempt employer subject to § 457 of the Code.[272] It applies when an offshore service recipient pays compensation to a taxable service provider on a deferred basis, but derives no tax benefit upon payment. If the offshore

[270] Congressman Rangel's report included with H.R. Rep. No. 431, 110th Cong., 1st Sess. (2007), regarding an earlier version of the bill includes the following passage:

> Under present law, there is a tension in the case of a nonqualified deferred compensation agreement between a service provider and a taxable service recipient. This arises because the timing rule under the Code defers the service recipient's deduction for nonqualified deferred compensation until the taxable year in which such compensation is includible in the service provider's gross income. This tension may limit the amount of compensation that a service recipient is willing to permit a service provider to defer under a nonqualified deferred compensation arrangement ... The Committee has become aware of other situations in which the present law tension does not exist. Specifically, foreign corporations that are not subject to a comprehensive income tax and partnerships that are comprised of foreign persons and U.S. tax-exempt entities are indifferent to the timing of deductions for nonqualified deferred compensation.

[271] See H.R. 6049, Renewable Energy and Job Creation Act of 2008; S. 3335, The Jobs, Energy, Families, and Disaster Relief Act of 2008.

[272] § 457 of the Code limits the amount of deferred compensation payable to a service provider to a tax-exempt or governmental organization. Recognizing the lack of negotiating tension in this context, § 457 limits the amount of vested nonqualified deferred compensation that may be credited to the service provider.

employer operates in a tax haven (e.g., a Cayman hedge fund organized as a foreign corporation), it will derive no tax benefit upon payment because it is exempt from net basis taxation. It may also apply to an offshore employer that operates in a non-tax haven jurisdiction, but imposes timing rules for the deduction of compensation that differ from those that would apply in the domestic context. If, for example, an offshore employer in a high-tax jurisdiction would not be entitled to claim a deduction upon actual payment, or would be entitled to the deduction solely upon accrual, the tax-based tension between the service recipient and the service provider is absent.[273]

Proposed Section 457A addresses the service recipient's "indifference" to the deduction by accelerating taxation of the service provider's deferred compensation to the date on which the right to payment is no longer subject to a substantial risk of forfeiture. Consistent with the policy rationale of the bill, it does not apply if the service recipient is subject to "comprehensive foreign income tax." For this purpose, a person is considered to be subject to "comprehensive foreign income tax" if (i) such person is eligible for the benefits of a comprehensive income tax treaty between the foreign country and the United States; or (ii) such person demonstrates to the satisfaction of the Secretary that such country has a comprehensive income tax.[274] Prior versions of the bill (both H.R. 3996 and H.R. 4351) also required the foreign tax regime to provide rules for the

[273] See also Senate Finance Committee staff summary of S. 3335 ("Where an individual is paid deferred compensation by a tax indifferent party (such as an offshore corporation in a tax haven jurisdiction), there is no offsetting deduction that can be deferred. As a result, individuals receiving deferred compensation from a tax indifferent party are able to achieve the tax benefits of deferred compensation at the expense of the Treasury.").

[274] Section 457A(d)(2).

deductibility of deferred compensation "similar to" the rules governing such compensation in the United States.[275]

For similar reasons, Section 457A also does not apply to (i) a foreign corporation substantially all of the income of which is "effectively connected" with the conduct of a U.S. trade or business;[276] (ii) a foreign corporation not subject to tax under § 882 on substantially all of its income, but that would be eligible to claim a deduction "against such [effectively connected] income" by paying the compensation on the date that the right to such payment was no longer subject to a substantial risk of forfeiture;[277] or (iii) partners of a partnership, where the partnership allocates substantially all of its income to persons other than (A) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax or (B) tax-exempt organizations.[278]

4. Technical Comments

As in the case of the proposed carry legislation, we make no comment on the underlying policy judgments regarding fee deferrals in this context. We instead offer the following technical comments:

First, the proposed legislation is likely to prohibit most fee deferrals by the primary intended targets of the legislation, which are U.S.-based managers of investment

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[275] In both of the prior bills, proposed Section 457A(d)(2) provided that a comprehensive foreign income tax "shall not include any tax unless such tax includes rules for the deductibility of deferred compensation which are similar to the rules of this title".

[276] Section 457A(b)(1)(A).

[277] Section 457A(d)(4).

[278] Section 457A(b)(2). The bill also excludes certain short-term deferrals. See Section 457A(d)(3)(B).

funds that derive no material tax benefit from the compensation deduction. Fund managers that defer incentive fees tend to do so when the underlying income of the fund is not subject to meaningful net basis taxation, either in the United States or elsewhere. Accordingly, the income of a typical "fee-deferring" fund will neither be effectively connected with the conduct of a U.S. trade or business nor subject to comprehensive foreign income tax. We note, however, that a foreign entity that is eligible for the benefits of a comprehensive income tax treaty may not be subject to "comprehensive foreign income tax" in its home jurisdiction. It may be possible, therefore, for a fund manager to circumvent the provisions of the bill by organizing the fund vehicle in a jurisdiction that is party to a comprehensive foreign income tax treaty with the United States, even though the fund itself is exempt from significant local tax. This can happen when the jurisdiction is not a tax haven, but instead grants special tax relief to certain types of entities, including the fund vehicle. In Ireland, for example, a "Section 110 Company" may claim the benefits of the income tax treaty between the United States and Ireland yet avoid significant Irish tax. A "Section 110 Company" is a special purpose vehicle in Ireland formed for the purpose of owning "qualifying assets" (e.g., stock, bonds, securities, various derivatives). Although resident in Ireland and subject to Irish tax at a 25% rate, these companies generally pay out all or substantially all of their income in the form of deductible expenses, reducing their tax base to a *de minimis* amount. Moreover, the equity capitalization of these entities is often nominal and held by a charity, with the "real" equity assuming the form of a contingent note or other security that provides for debt service or other deductible payments equal to the anticipated net

profits of the entity.[279] Nevertheless, so long as the entity is eligible to claim treaty benefits,[280] 457A would treat it as subject to "comprehensive foreign income tax". The bill would therefore exempt a fee deferral arrangement with such an entity.[281] Rather than grant a blanket exemption for deferral arrangements with any foreign entity that is eligible to claim treaty benefits, we recommend that Congress revise the bill to require a foreign entity to be subject to actual comprehensive foreign income tax, with no automatic relief for treaty eligible entities. To address the resulting uncertainty that the existing provision was probably intended to eliminate, the statute could grant regulatory authority to Treasury to identify eligible foreign jurisdictions.[282]

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[279] For a more general description of the nature and taxation of these entities, see "Ireland as the European Location of Choice for Securitization", Ernst & Young (2003) (available at http://www.irelandturkey.org/downloads/1090250202.pdf); G. Ferguson, "Ireland: A Prime Location for Global Structured Finance - the Legal and Taxation Analysis" (available at http://www.finance-magazine.com/supplements/ssfc2006/display_article.php?aid=6413); "Establishing Special Purpose Vehicles in Ireland", Arthur Cox (June 2005) (available at **Error! Hyperlink reference not valid.**). We understand that Luxembourg also grants similar relief to other types of entities, including entities eligible to claim treaty benefits under the current income tax treaty between the United States and Luxembourg.

[280] So long as the Section 110 Company makes a sufficient percentage of the deductible payments to either U.S. persons or other qualified persons, the "base erosion" rules under the LOB provisions of the Irish Treaty will not apply. See Convention between the government of the United States and the government of Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains (the "Irish Treaty"), Art. 23, paragraph 2.c. To qualify for benefits under the Irish Treaty, a Section 110 Company must satisfy certain ownership tests. One method of doing so is to satisfy Article 23(5)(a)(ii) of the Irish Treaty, which requires that seven or fewer "qualified persons" own, directly or indirectly, at least 95% of the aggregate vote and value of the company's shares. For this purpose, a qualified person is defined in Article 23(2) to include residents of member states of the European Union ("EU") or of parties to the North American Free Trade Agreement ("NAFTA"). Moreover, so long as the Section 110 Company pays no more than 50% of its gross income to persons that are not qualified persons or persons that are not residents of either member states of the EU or parties to NAFTA, it would also avoid the "base erosion" limitations under Article 23.

[281] See Section 457A(d)(2)(A). We have assumed that these special relief provisions under local law would not disqualify the Irish Treaty as a "comprehensive income tax treaty" within the meaning of the bill.

[282] In addition, the statute might also provide for a streamlined process whereby taxpayers could request an advance determination that a particular jurisdiction imposes a comprehensive foreign income tax.

Second, the bill should restore the additional requirement of the predecessor bills that the foreign tax regime, whether or not a treaty partner, provide rules regarding the deductibility of compensation "similar to" the rules that govern such compensation under the Code.[283] If, for example, a foreign jurisdiction were to impose a comprehensive income tax but prohibit any deduction for compensation, a service recipient in such a jurisdiction would be just as tax indifferent to a fee deferral as a service recipient in Bermuda. On the other hand, the bill should not necessarily apply to a foreign tax regime that differs in significant respects from the U.S. tax regime but provides rules relating to the payment of compensation by the actual service recipient that do not. For example, suppose that the foreign tax regime did not compel all service recipients to report compensation expense on the cash method, but that a particular service recipient did report on the cash method. Section 457A should not apply in such a case.

Third, recent experience with § 409A has demonstrated that, particularly with respect to a complex new statute, broad grants of regulatory authority are imperative. Proposed Section 457A(e) already provides latitude to Treasury to enact regulations necessary or appropriate to effectuate the purposes of the bill, including the ability to disregard, where appropriate, a substantial risk of forfeiture. Consideration should be given to broadening Treasury's authority even further, permitting it to alter the manner in which Section 457A operates by legislative regulation as necessary to reflect the intent of Congress. In this way, if an issue requires immediate attention, Treasury may address it by regulation. We do not believe it is possible to anticipate every case in which the

[283] See H.R. 4351, Section 457A(d)(2).

statute may apply too broadly to a valid deferral arrangement or too narrowly to an invalid deferral arrangement. For example, the bill borrows the definition of "nonqualified deferred compensation" from § 409A(d), subject to the exception that it also includes any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient. § 409A, however, is a compliance statute. It does not prohibit all deferrals, but rather establishes rules for limiting deferrals to those regarded as proper. Section 457A, on the other hand, either bars deferrals altogether or penalizes them by imposing a substantial penalty.[284] The distinct orientation of these two provisions makes it critical that Treasury have broad discretion to provide for rules, including rules that diverge from the presumptive statutory language, in order to implement Section 457A in accordance with Congressional intent.

Finally, we note that § 409A, which is itself far more broad than Section 457A, does not apply to most forms of equity-based compensation, including "at-the-money" options, restricted stock and other service grants of property under § 83. We recommend that Congress clarify that Section 457A does not apply to any equity-based compensation that is exempt from § 409A. Indeed, most forms of equity-based compensation that would otherwise fall within Section 457A are likely to constitute either ISPIs or "disqualified interests" under Section 710 of the Bill. As such, these types of grants will already be subject to service taxation under separate and distinct rules.

[284] Section 457A(c)(1) (deferring taxation of any amount otherwise includible in gross income that is not "determinable", but imposing an interest charge and an additional tax equal to 20% of the amount of the compensation when such amount becomes determinable).