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Senate Proposal Would End Deferral for Carried Interest

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On May 23, 2019, ranking member of the Senate Finance Committee Ron Wyden (D-OR) introduced a bill entitled "Ending the Carried Interest Loophole Act" (the "bill").

- Under the bill, if a partnership interest is received in connection with the performance of services for an investment partnership, the service partner will take into income annually a "deemed compensation amount."
- The deemed compensation amount is taxable to the service partner at ordinary income rates and is also subject to self-employment tax.
- The deemed compensation amount is taxable annually regardless of whether any assets are sold, income is allocated or cash is distributed to the service partner.

For example, based on the bill's formula (described in detail below, and assuming the relevant interest rate is 3%), a sponsor who invests $1 million in a venture, raises an additional $9 million for the venture, and receives a 20% promote or carry, would have $120,000 of ordinary compensation income each year, regardless of whether the venture has any income or gain.

The sponsor also receives a capital loss in that amount. When the asset generating the allocation and distribution of promote or carry is sold, the sponsor can use the capital loss to offset some of the capital gain from the sale.

In Depth

The bill treats carried interest like an interest-free loan from the investors to the service partner (typically the sponsor). It calculates the service partner's deemed compensation amount by applying a standard rate of return to the portion of the other investors' capital used to invest for the service partner's own account. The resulting "deemed compensation amount" is equal to the forgone interest on the deemed loan from the investors.

More precisely, the formula provided by the bill for computing the deemed compensation amount is:

Deemed Compensation Amount =

Specified Rate × ((Applicable Percentage × Invested Capital of all Partners) – Invested Capital of

Service Partner)

Where:

- *Specified Rate* = the par yield for 5-year High Quality Market corporate bonds for the first month of the calendar year with or within which the partnership's tax year begins, plus 9 percentage points;
- *Applicable Percentage* = with respect to any partnership interest, the highest percentage of profits of the partnership that could be allocated with respect to that partner (consistent with the partnership agreement and determined as if all performance targets with respect to such interest had been met);
- *Invested Capital* = with respect to any partner as of any day, the excess of:
    - the sum of the total cumulative value determined at the time of contribution of all amounts contributed by the partner as of that day (reduced by liabilities assumed by the partnership in connection with the property); plus
    - the aggregate amounts of the partner's distributive share of income and gain (other than unrealized gains resulting from revaluations of partnership property) as of such day; over
    - the aggregate value, determined at the time of distribution, of all amounts distributed to the partner from the partnership as of such day (reduced by liabilities assumed by the partner in connection with the distributed property); plus
    - the aggregate amount of the partner's distributive share of loss and deductions of the partnership as of such day (determined without regard to unrealized losses resulting from revaluations of partnership property).

For example, if a service partner's invested capital is $500,000, the invested capital of all partners is $10,000,000, the service partner's applicable percentage is 10%, and the specified rate is 12%:

Deemed Compensation Amount = ***$60,000***

12% × ((10% × $10,000,000) – $500,000)

The bill provides means for calculating the inclusion of a deemed compensation amount for a given year even where the partnership interest is disposed, and contains a reporting requirement for the partnership of deemed compensation amounts. The bill also repeals the newly enacted Section 1061 of the Code which requires a three year holding period for carried interest assets.

If you have a question about this development, we invite you to reach out directly to the authors, Leah B. Segal or Jonathan Stein*, or any member of our* *Tax Group*.