AICPA®

American Institute of CPAs
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March 7, 2011

The Hon. Max Baucus, Chairman
Senate Committee on Finance
511 Hart Senate Office Bldg.
Washington, DC 20510

The Hon. Dave Camp, Chairman
House Committee on Ways & Means
1236 Longworth House Office Bldg.
Washington, DC 20515

The Hon. Orrin G. Hatch
Ranking Member
Senate Committee on Finance
135 Hart Senate Office Bldg.
Washington, DC 20510

The Hon. Sander M. Levin
Ranking Member
House Committee on Ways & Means
341 Cannon House Office Bldg.
Washington, DC 20515

Re: AICPA Proposed Modifications to Carried Interest

Dear Chairmen Baucus and Camp, and Ranking Members Hatch and Levin:

The AICPA appreciates the opportunity to present its views and to suggest changes to the proposals previously under consideration that would modify the treatment of income for partners providing investment management services to partnerships (the so-called "carried interest" rules). While, the AICPA does not endorse any carried interest proposed legislation, should Congress decide to take action on this legislation, the AICPA believes that the Congress should consider the technical modifications addressed below in order to eliminate ambiguities, create greater consistency with other areas of the tax law, avoid unnecessarily elevating form over substance, and reduce compliance burdens on small taxpayers.

Background

Currently partners that hold a partnership interest received in exchange for services to an investment partnership report their share of income based on the type of income the partnership reports, such as dividends or capital gains. Some Members of Congress have been concerned for several years that these partners are paying a lower (capital gain) tax rate on income that was received for services, and, thus, have proposed that this income be treated as other compensation, taxed at ordinary income rates and subject to employment taxes. Several versions of the carried interest proposal have been considered since 2007[1], but have not been enacted. In 2010, legislation was again introduced in the House of Representatives and, for the first time, in the

[1]See HR 2834 (introduced by Rep. Sander Levin June 2007); HR 3996 (introduced by Rep. Charles Rangel Oct 2007 and passed House November 2007); HR 6275 (introduced by Rangel June 2008 and passed House a week after introduction); HR 4213 (various versions of carried interest were passed in this large and ever-changing bill by the House in Dec 2009 and May 2010); and S. 3793 (introduced by Sen. Max Baucus September 2010). Other bills and proposals affecting carried interest were also introduced by Congress and the Administration, including most recently in the *Administration's Fiscal Year 2012 Revenue Proposals*.

Senate, that would (1) tax as ordinary income any net income received on an investment services partnership interest (ISPI) (proposed section 710) and (2) subject that income to self-employment tax (proposed section 1402(a)(18)). In addition, losses allocated to such interests generally would be deductible as ordinary losses. However, these losses would not be deductible as ordinary unless the partner had been allocated recharacterized section 710 income from that particular partnership. Under the latest proposals, section 710 would apply to all interests received for providing investment advisory and asset management services to a partnership, including partnerships that invest in securities, other partnerships and real estate, whether the real estate is held for investment or for rental purposes.

The proposed Code sections cited in this letter are those that would be added under S. 3793, the *Job Creation and Tax Cut Act of 2010*, as introduced by Senator Baucus on September 16, 2010.

Specific Comments

TREATMENT OF DISTRIBUTIVE SHARE OF PARTNERSHIP ITEMS

1. Proposed section 710(a)(1)(A) provides that any net income with respect to a partner covered by the provision would be ordinary income. It is unclear if this section overrides the exclusion of an item from gross income (such as cancellation of indebtedness income), or just eliminates its characterization as a capital gain item. For example, if a partner receives an allocable share of cancellation of indebtedness income attributable to his ISPI that such partner could otherwise exclude under section 108(a), does this section cause the otherwise excluded income to be fully taxable ordinary income or is it still excluded under section 108?

   The AICPA recommends clarification regarding what the term "net income" in proposed section 710(a)(1)(A) includes. We ask that an example be included in the legislative history clarifying that items that are excluded from income under any provision of the Code are not considered part of net income under proposed section 710(a)(1)(A) and not subject to self-employment tax.

TREATMENT OF LOSSES

2. While the proposed section taxes income as ordinary income, it also allows losses, to the extent deductible under its provisions, to be treated as ordinary deductions. Generally, allowing the partner an ordinary deduction rather than requiring losses to flow through from the partnership as capital losses is a favorable provision for taxpayers. However, because the losses would be subject to deferral under proposed section 710(a)(2), and the calculation for the amount of loss that would eventually be allowed can be complex, some partners may want to take the loss currently as a capital loss.

The AICPA recommends that a section 710(a)(1)(C) be added to allow the partner to elect out of the loss rules of proposed sections 710(a)(1)(B), 710(a)(2) and 710(b)(2). If the partner elects out of proposed section 710(a)(1)(B), the partner will be allowed a current loss, the character of which is based on the underlying distributive share, generally a capital loss. This election, with respect to all current and future year losses, should be made the first year the partner is subject to the section 710 rules and should be effective for the life of the ISPI to prevent partners from choosing to treat the losses as capital in years when it is more advantageous for them and as ordinary in other years.

3. In proposed section 710(a)(2)(A), Congress proposes to limit the amount of net losses a service partner will be able to deduct. According to the proposed section, service partners will only be allowed to deduct losses if they had previously reported income from that partnership that was recharacterized as ordinary under section 710. The proposed law is applied on a partnership-by-partnership basis.

   The AICPA suggests that any losses deferred under the proposed legislation be aggregated such that any net ISPI losses can be deducted against any ISPI net income. Thus, the net loss limitation would be an aggregation of all ISPIs (similar generally to the treatment of passive income and losses under section 469).

TAX CONSEQUENCES UPON DISPOSITION OF PARTNERSHIP INTERESTS

4. Proposed section 710(b)(2)(B) provides that a net loss that is not allowed by reason of proposed section 710(b)(2)(A) shall be carried forward and treated as an item of loss with respect to the ISPI for the succeeding partnership taxable year. The AICPA requests statutory clarification as to how suspended losses are treated upon a taxpayer's disposition of its entire interest in an ISPI, that is, do unused suspended losses disappear, or are there situations where the suspended losses carry over to the transferee, such as a gift to a related person or pursuant to a divorce or in connection with the transfer of the ISPI to a new partnership for which the transferor makes the election under proposed section 710(b)(3)?

5. Proposed section 710(b)(1)(B) generally requires a taxpayer to recognize gain on the disposition of an ISPI notwithstanding any other provision of subtitle A of the Internal Revenue Code. The AICPA notes that nonrecognition rules involving transfers between spouses and former spouses, gifts, transfers upon death, and similar related-party transfers would seem to be nullified by proposed section 710(b)(1)(B) and requests statutory clarification (or change, if necessary) as to whether this reading of the rule truly reflects congressional intent.

DISTRIBUTION OF PARTNERSHIP PROPERTY

6. In general, property moves into and out of a partnership without taxation. There are some exceptions such as the "mixing-bowl rules" of sections 704(c)(1)(B) and 737, or the rules of sections 731(c) or 751(b), that generally relate to shifting built-in gains among the partners. Under the proposed legislation, if a partnership distributes appreciated property to a holder of an ISPI, the partnership recognizes gain equal to the excess of the FMV of the asset over its tax basis. Then, the partner is treated as receiving cash (rather than property), which could cause additional income from a distribution in excess of basis. Most of the income will be ordinary income subject to self-employment tax. While it may be reasonable to not allow the ordinary income taint to be eliminated by a distribution, it does not appear to be proper to trigger the ordinary income currently for a property distribution. For example, the distribution may be pro rata to all the partners and outside the control of the partner. Moreover, the partner may receive illiquid property and have no cash to pay the tax. Further, if the property is considered a payment for services, it is not clear whether the partnership would receive a deduction for this payment.

   The AICPA suggests changing proposed section 710(b)(5) so that it allows the normal rules for property distributions (including for marketable securities) from a partnership to apply, but locks in the ordinary income element and employment tax implications of those distributions for recognition upon a subsequent sale of the property by the distributee partner. Tracking the ordinary income over time may add some complexity; however, it is not unusual for partners receiving property from a partnership to have to track a part of the built-in gain in the asset for future transactions. For example, if there is a pro rata distribution of property subject to potential section 1245 recapture, the partner needs to track that amount.

EXCEPTIONS

7. As reflected above, proposed section 710 would significantly modify present law treatment of income from a service partnership and impose significant complexity and compliance burdens. Recordkeeping, the character of income, the treatment of losses, and the treatment of partnership distributions would all become significantly more complex. The proposal currently contains only two exceptions to address such concerns: (1) the exception for family farms and (2) the exception for partnerships with pro rata allocations based on capital.

   The AICPA believes Congress should consider one or more additional exceptions to proposed section 710(c)(3) that would prevent small, and perhaps informal, partnerships from falling within the new rules. Such exceptions could be based on a combination of factors including: the value of partnership assets; the capital of the partnership; the type of partnership assets; the number of hours devoted to partnership matters or the amount of compensation received by service partners; the number of partners; and the relationships between partners.

8. Partnership interests can constitute ISPIs for partnerships that invest in securities, real estate held for investment or rental, and partnership interests. It appears that interests in operating partnerships held through a holding partnership could cause the upper tier holding partnership interest to become an ISPI even in situations where the partnership interests would not have been ISPIs if the service partner had held its interest in the lower-tier partnership directly.

   The AICPA suggests that an exception be added for operating partnerships that own more than 50 percent of a lower-tier partnership. In this case, the upper-tier partnership would itself qualify as an "operating partnership" under a look-through rule where the assets of the lower-tier are attributed to the upper tier partnership. Such an exemption is intended to include operating businesses held in tiered partnership arrangements. Note that a traditional private equity fund with assets solely comprised of majority interests in operating partnerships may also qualify for the exception; however, the interests in the general partner or managing member of such a fund would not qualify for the exception as such entities typically do not themselves hold controlling interests in the fund.

9. Partnership interests can constitute ISPIs for service partners of operating businesses where such service partners hold their interests through a tiered arrangement.

   The AICPA suggests that an exception be added to the statutory language for such interests where any upper-tier partnership interest is held by a service provider if such partnership interest would not have qualified as an investment services partnership interest if such partner instead held an interest directly in the lower-tier partnership. For this exception to apply, the substantial services of the service partner must relate to the day-to-day business of an operating partnership where such business does not relate to management of a specified asset.

10. The AICPA believes there may be a mechanical issue related to the allocation of income from the appreciation of partnership assets where additional capital interests are created through revenue earned but not distributed. Where an ISPI earns ordinary income and that income is not distributed, this increase in capital is treated as a Qualified Capital Interest (as defined in proposed section 710(d)(7)). The new investment will fund further asset acquisitions, etc., where the ISPI and the Qualified Capital Interest of the same partner will both participate in the growth of the partnership assets – but it will be very difficult to separate and allocate this appreciation between the two types of interests.

The AICPA recommends that the legislation give the Commissioner the authority to waive the single basis rule for partnership interests. This would allow the partner to treat each partnership interest as separate with a separate capital account and separate basis as if the interests were owned by different partners.

PENALTIES

11. The proposed legislation will be applied to all carried interests that are ISPIs. Partnership interests can constitute ISPIs for partnerships that invest in securities, real estate held for investment or rental, and other partnership interests. Though many investors may have heard of the new legislation, they may not understand how far reaching the rules are.

    The AICPA recommends that several changes be made to the proposed underpayment penalty to help ensure that the penalty is applied fairly to all taxpayers and to encourage voluntary compliance. For example, given the potential breadth of the legislation, we believe that the penalty rate should be the standard accuracy-related penalty rate of 20 percent, rather than the higher rate of 40 percent. In addition, the proposed rules for reasonable cause relief from the penalty are too harsh given the inevitable uncertainties as to how the new rules will be interpreted and applied. Thus, we recommend that the general reasonable cause rules of section 6664 apply (reasonableness and good faith) instead of the stricter approach applicable to reportable avoidance transactions under section 6662A (disclosure, substantial authority, and reasonable belief that the position is more likely than not correct). In particular, we do not believe it is appropriate to deny relief from the penalty to a taxpayer who acted reasonably and in good faith merely because the taxpayer did not disclose a given return position. As noted above, in some cases, taxpayers legitimately may not realize the new rules apply or may misinterpret how they apply and, therefore, would not have made any disclosure.

The AICPA believes that the technical changes to the proposed legislation suggested above will reduce ambiguities, provide greater consistency with other areas of the tax law, prevent the favoring of form over substance, and avoid undue burdens on the ordinary activities of smaller taxpayers.

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The AICPA is the national professional organization of certified public accountants comprised of nearly 370,000 members. Our members advise clients on federal, state and international tax matters, and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized business, as well as America's largest businesses.

If you have any questions about this matter, please contact Sarah Staudenraus, Chair of the Partnership Tax Technical Resource Panel at (202) 533-4574 or sarahstaudenraus@kpmg.com; Hughlene A. Burton, Chair of the Carried Interest Task Force at (704) 687-7696 or hughlene.burton@uncc.edu; or Marc A. Hyman, AICPA Technical Manager at (202) 434-9231 or mhyman@aicpa.org.

Sincerely,

Patricia A. Thompson
Chair, Tax Executive Committee

CC: The Honorable Members of the House Ways & Means Committee
The Honorable Members of the Senate Finance Committee
The Honorable Michael F. Mundaca, Assistant Treasury Secretary (Tax Policy)
The Honorable Douglas H. Shulman, Commissioner of Internal Revenue
Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Cecily Rock, Senior Legislation Counsel, Joint Committee on Taxation
Holly Porter, Tax Counsel, Senate Finance Committee