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Client Alert

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Tax Extenders Act of 2009 Would Tax Income and Gain From Certain Partnership Interests as Ordinary Income

On December 9, 2009, the US House of Representatives passed the Tax Extenders Act of 2009 (the Bill), which not only extends certain expiring tax provisions, but also includes some revenue raising provisions, including one that would tax income and gain derived with respect to certain partnership interests held by service providers as ordinary income. These provisions of the Bill are substantially similar to the provisions of the bills introduced by Representative Sander Levin (D-MI) in April 2009 and June 2007. While it is not clear whether this legislation will be enacted in its current form, or at all, the following discussion summarizes certain key provisions related to these provisions in the Bill.

> "Under the Bill, any net income derived with respect to an investment services partnership interest would be taxable as ordinary income, irrespective of the character of the partnership's underlying income."

Current Law. Entities classified as partnerships for federal income tax purposes are "pass-through" entities that are not required to pay federal income tax. Rather, partners or members of such entities are allocated, and are generally required to pay tax with respect to, their *pro rata* shares of the items of ordinary income and net capital gain, of the entity, whether or not they receive a distribution of cash from the entity. Under current law, a person providing services to or for the benefit of a partnership may receive a "profits" interest in the partnership without currently recognizing gain or loss provided that certain requirements are met. Instead, the service provider will be allocated his or her *pro rata* share of the partnership's ordinary income and net capital gain with respect to the profits interest, as described previously.

Receipt of Partnership Interest in Connection with the Performance of Services—Section 83. The Bill provides that a partner who receives a partnership interest in connection with the performance of services to or for the benefit of the partnership must include in income the liquidation value of such interest (*i.e.*, the amount the partner would receive if the partnership sold its assets, satisfied its liabilities and distributed the proceeds to the partners in liquidation of their interests). This provision in effect codifies the rules set forth in existing Internal Revenue Service guidance. Further, unless the service provider elects otherwise, the service provider will be treated as having made an election under Section 83(b) of the Internal Revenue Code of 1986, as amended (the Code) with respect to such interest. Under Section 83(b) of the Code, a taxpayer may elect to include in taxable income in the year of receipt the fair market value of property transferred in connection with the performance of services over any amount paid for such property.

Under the Bill, a partner who receives a partnership interest in connection with the performance of services would be treated as the owner of the transferred property notwithstanding any forfeiture or transfer restrictions unless the partner elects otherwise. In the case of a profits interest, this treatment is beneficial to the service provider because the liquidation value, and therefore the amount required to be included in income, will be zero.

Treatment of Investment Services Partnership Interests. The Bill also provides rules with respect to "investment services partnership interests" which generally include partnership interests held directly or indirectly by any person if it was reasonably expected, at the time of the receipt of such interest, that the partner or a related party would provide, directly or indirectly, a "substantial quantity" of certain specified services (generally, management and advisory services) with respect to "specified assets" held, directly or indirectly, by the partnership. "Specified assets" generally include securities, rental or investment real estate, interests in partnerships, commodities, or options or derivative contracts with respect to any such assets.

Under the Bill, any net income derived with respect to an investment services partnership interest would be taxable as ordinary income, irrespective of the character of the partnership's underlying income. In addition, any gain recognized in connection with a disposition of such an interest (including in an otherwise non-taxable transaction, such as a tax deferred contribution to a corporation or partnership) or upon the distribution of property to the partner by the partnership would also be treated as ordinary income. Losses allocated with respect to an investment services partnership interest would be treated as ordinary loss to the extent of the aggregate net income allocated with respect to such interest for periods during which the legislation is in effect, and any excess loss would be carried forward until income is allocated with respect to such interest in future years or such interest is sold. Thus, any loss recognized on the disposition of an investment services partnership interest would be treated as ordinary loss to the extent of prior ordinary income inclusions with respect to such interest that were not offset by prior year losses. Moreover, amounts treated as ordinary income or loss under these rules would be included in determining net earnings from self-employment, and amounts treated as ordinary income would be subject to self-employment tax.

The Bill provides that the Treasury Department may issue regulations to carry out the purposes of these new provisions. In the discussion of this regulatory authority, the House summary of the Bill (the House Summary) provides that the recharacterization of income as ordinary income is not intended to cause a REIT that otherwise meets the REIT gross income and asset test requirements to fail to meet those requirements. Similarly, any recharacterization under these provisions is not intended to cause income that is not otherwise treated as unrelated taxable income to a tax-exempt investor to be treated as such.

Exception for Certain Qualified Capital Interests. The Bill provides an exception to the treatment previously described for a "qualified capital interest" held by a service provider, provided allocations are made by the partnership to such interest in the same manner as to similar interests held by unrelated partners who are not service providers. In addition, except as otherwise provided in Treasury Regulations or other guidance, allocations made to the interests held by such non-service providers must be significant compared to the allocations made to the service provider's qualified capital interest. A qualified capital interest is the amount of a partner's interest in partnership capital attributable to (i) the fair market value of money or other property contributed to the partnership (without regard to the fact that a partner's assumption of partnership liabilities is treated as a contribution of money to the partnership under applicable tax rules); (ii) any amounts included in income under Section 83 of the Code with respect to the transfer of the interest; and (iii) any taxable net income allocated to the partner for taxable years to which the legislation applies. A qualified capital interest is reduced by distributions to the partner and allocations of taxable net loss for taxable years to which the legislation applies.

For purposes of the legislation, a qualified capital interest does not include an investment services partnership interest acquired by the service partner with the proceeds of a loan or advance made or guaranteed by the partnership, another partner or a related party. In addition, the House Summary states that in the case of a transfer of an investment services partnership interest, the transferee will succeed to the transferor's qualified capital interest, irrespective of the amount paid for such interest. It is also important to note that since a qualified capital interest is increased only by net income allocated with respect to such interest for taxable years when the legislation is effective, allocations with respect to profits interests (including those received pursuant to a management fee waiver program) prior to such date will not be treated as increasing such partner's qualified capital interest in the applicable partnership. Conversely, taxable income allocations for taxable years when the legislation is effective (including allocations made with respect to a profits interest that is received in connection with a management fee waiver program) will be treated as increasing a partner's qualified capital interest.

Treatment of Certain Disqualified Interests. The Bill further provides that income or gain derived from certain "disqualified interests" with respect to an entity will be treated as ordinary income where a person performs, directly or indirectly, investment management services for the entity and the value of (or payments with respect to) the interest is substantially related to the realized or unrealized income or gain from the assets with respect to which such services are performed. A "disqualified interest" generally includes, with respect to an issuer, (i) any interest in such entity other than debt; (ii) convertible or contingent debt; (iii) options to acquire interests described in (i) and (ii); and (iv) certain derivative instruments.

A disqualified interest does not include partnership interests or, except as otherwise provided in Treasury Regulations or other guidance, stock in S corporations or interests in taxable corporations, including US C corporations and non-US corporations the income of which is effectively connected with the conduct of a US trade or business or subject to a comprehensive foreign income tax. The House Summary notes, however, that an option to acquire a partnership interest may be treated as a disqualified interest and that the exceptions for stock in an S corporation or domestic US C corporation are not intended to permit avoidance of these rules through economically similar arrangements. In addition, to illustrate an example of a corporation not subject to a comprehensive income tax, the House Summary provides an example where a hedge fund manager owns stock of a Cayman Islands corporation that is a partner in a hedge fund for which the manager provides investment management services. The example concludes that dividends on and gain with respect to the sale of stock in the corporation are treated as ordinary income and are subject to self-employment tax, because the value of the stock and dividends with respect to such stock are substantially related to the performance of the hedge fund's assets.

Publicly Traded Partnerships. Under current law, partnerships that are treated as "publicly traded partnerships" generally are taxable in the same manner as taxable C corporations. However, if a partnership that otherwise would be treated as a publicly traded partnership derives at least 90 percent of its gross income from certain passive sources, including interest and dividends, it will not be required to pay tax in the same manner as a corporation. The Bill provides that income and gain treated as ordinary income under the rules described in this *Alert* will not constitute qualifying passive income for purposes of the publicly traded partnership rules. However, for publicly traded partnerships in existence on the date of enactment, this rule will not apply until 10 years after such date.

The Bill provides an exception to this rule for certain partnerships owned by publicly traded REITs where (i) the partnership is treated as publicly traded solely by reason of its interests being convertible into stock of the public REIT; (ii) at least 50 percent of the capital and profits are owned, directly or indirectly, during the taxable year by the REIT; and (iii) the partnership satisfies the gross income and asset tests applicable to REITs.

Effective Dates. The provisions related to the treatment of partnership interests transferred in connection with the performance of services under Section 83 of the Code would apply to transfers of interests after the date of enactment. The provisions relating to the treatment of income from a partnership as ordinary income would apply to taxable years ending after December 31, 2009, although special rules are provided for allocating income in taxable years that include December 31, 2009. The provisions related to partnership distributions and dispositions of partnership interests would apply to distributions and dispositions after December 31, 2009. The provisions related to disqualified interests would apply beginning on January 1, 2010. Finally, the amendments related to publicly traded partnerships would apply to taxable years beginning after December 31, 2009.

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