GOODWIN PROCTER

Goodwin Procter LLP
Counselors at Law
Exchange Place
Boston, MA 02109
T: 617.570.1000

PRIVILEGED AND CONFIDENTIAL

MEMORANDUM

To	Our Clients and Friends
From	Goodwin Procter LLP
Re	Carried Interest Update
Date	May 27, 2009

This memorandum summarizes the key features of the latest proposals to tax gain from carried interests as ordinary income as they would apply to the typical U.S. private equity or venture capital fund and the individuals who hold carried interests in those funds.

I. Background

For decades, individual sponsors of private equity, venture and real estate funds have relied upon the flow-through nature of partnership taxation to obtain favorable U.S. federal income tax treatment of their carried interests.[1] Under current law, to the extent that a fund's profits consist of long-term capital gains, the sponsor's carried interest share of those profits is taxed to the sponsor at the favorable capital gains rates, generally 15% for federal income tax purposes.[2] Furthermore, the grant of a carried interest is a non-taxable event.

In recent years, some members of Congress took notice of the favorable tax treatment of carried interests, especially in the context of the private equity industry, and beginning in 2007, attempted to pass legislation that would tax carried interest income as ordinary compensation income. While both houses of Congress have yet to successfully enact carried interest legislation into law, the Obama Administration recently weighed in by including carried interest taxation reform as a revenue raising measure in its fiscal year 2010 budget.

1 This memorandum uses the term "carried interest" to mean a share of future partnership profits (over the fair market value of partnership's assets on the date of grant) issued to a general partner or other service partner. The term "private equity fund" is meant to encompass venture, LBO, real estate and other investment funds.

2 The current long term capital gain and ordinary income rate structure is scheduled to sunset at the end of 2010. The Obama Administration has indicated that it will not seek to renew these rates. If the current rates sunset, in 2011 the top long term capital gain rate will become 20% and the top marginal income tax rate, discussed below, will become 39.6%. Certain real estate capital gains are taxed at 25%.

The following is a timeline of the various Congressional and Administration carried interest proposals:

- October 30, 2007 – Representative Charles Rangel (D.NY) introduced H.R. 3996, Temporary Tax Relief Act of 2007, targeting carried interests in investment partnerships, which was passed by the House of Representatives on November 9, 2007. The bill failed to pass in the Senate. This bill was the simplest version of carried interest legislation, and practitioners identified several technical deficiencies in its operation and opportunities to plan around its effects.

- June 17, 2008 – Representative Charles Rangel (D.NY) introduced H.R. 6275, The Alternative Minimum Tax Relief Act of 2008 (the "Rangel Bill"), which was passed by the House of Representatives on June 25, 2008. The Rangel Bill failed to pass in the Senate. This legislation addressed several of the technical deficiencies and provisions that potentially could have been exploited in the prior legislation proposed by Representative Rangel.

- January 28, 2009 – Senator Jim Webb (D.VA) proposed Senate Amendment 58 to the Children's Health Insurance Program Reauthorization Act of 2009. The amendment was withdrawn on the same day. This bill was substantively identical to the Rangel Bill.

- February 26, 2009 – The Obama Administration issued its fiscal year 2010 budget proposal calling for legislation to tax carried interests as ordinary income beginning in 2011. This proposal contained no further description or statutory language.

- April 2, 2009 – Representative Sander Levin (D.MI) introduced H.R. 1935 (the "Levin Bill"), which generally tracks the approach of the Rangel Bill but contains some substantive modifications. The Levin Bill was referred to the House Committee on Ways and Means on April 2, 2009.

- May 11, 2009 – The U.S. Treasury published the *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*, (the "General Explanation"), which includes a short summary of the Obama Administration's apparent proposal to tax all carried interests as ordinary income (the "Administration Proposal") but no actual text of proposed legislation.

Because the Levin Bill is the latest example of detailed legislative text and reflects some technical refinements from prior proposals, and because the Administration has released only a short summary of its proposal, the following discussion focuses on the Levin Bill. To the extent that the summary in the General Explanation reveals differences (or similarities) between the Administration Proposal and the Levin Bill, those differences and similarities are noted in italics. However, the new tax regime for carried interests, if any is ultimately enacted, may not track any of the current proposals. The carried interest proposals have evolved over time, in large part to shut down perceived "loopholes" in prior proposals, and further evolution is likely. The Administration Proposal to expand the category of affected partnerships should certainly reinvigorate the debate over the proper treatment of carried interests and focus interest on the scope of any exceptions.

The proposals discussed below would cover any domestic or foreign entity treated as a partnership for U.S. federal income tax purposes (such as domestic LLCs and foreign entities that elect to be taxed as partnerships for U.S. purposes)[3] and, as discussed in Part VI below, certain other entities as well.

II. Basic Rules of the Carried Interest Proposals

The cornerstone of all of the carried interest proposals is a rule that would convert income and gain received on account of a carried interest into ordinary income. These proposals also provide new rules for the treatment of gain or loss on the disposition of a carried interest by a sponsor and the distribution of partnership property to the sponsor on account of a carried interest. These rules are discussed in detail below.

The Levin Bill targets mainly investment professionals and would apply only to carried interests that are "investment service partnership interests," the definition of which is discussed in Part IV below.[4] *The Administration Proposal appears to apply to any carried interest, irrespective of the activities of the partnership.*

Under the Levin Bill:

A. Net income allocations with respect to a carried interest would be treated as ordinary income.[5] Thus, the sponsor's carried interest share of partnership profits would be taxed at a federal marginal rate currently as high as 35% irrespective of the extent to which the fund's profits included long term capital gains. Note also that this rule would not change the usual partnership tax accounting rules for when the sponsor pays tax on such income, which is often in advance of the corresponding promote distributions, thus necessitating tax distributions.

B. Income and gain recharacterized under the foregoing rules would be subject to self-employment taxes to the extent ultimately allocated to an individual. In 2009, this is a rate of 15.3% for the first $106,800 of earnings and 2.9% for all subsequent earnings.[6]

C. Property distributions with respect to a carried interest would be treated as sales by the partnership, and the resulting gain would be required to be allocated to the carried interest holder as ordinary income. The private equity and venture capital

---

3 For simplicity, this memorandum refers to all such arrangements as partnerships.

4 The Rangel Bill also targeted only certain investment partnerships, although the term was defined slightly differently.

5 Net losses with respect to a carried interest (including losses on dispositions) would be treated as ordinary losses. However, the losses would only be allowed to the extent they do not exceed the aggregate net income previously recognized with respect to the carried interest over the prior years the Levin Bill was in effect. Any disallowed loss could be carried forward to the next taxable year, subject to the same limitations.

6 Although to our knowledge no concrete proposal has been advanced by the Obama Administration, there has been some talk of lifting the cap on Social Security contributions, which would result in a self-employment tax rate of 15.3% for all earnings (or if a new cap is imposed, earnings up to the new cap).

industries (outside of real estate) have long relied on in-kind distributions of marketable securities as a means of providing liquidity to their investors and general partners. Specifically, under current law, such funds generally can distribute marketable securities without current taxation, and the general partner will not recognize capital gain until it sells the securities so received. Indeed, not so long ago, Congress took pains to except investment partnerships from rules that tax some distributions of marketable securities. The carried interest proposals would accelerate the inclusion of income by the sponsor to the time the property is distributed by the partnership and convert the income to ordinary income, even if the property is retained by the sponsor. If the sponsor later sold the property at a loss, the resulting capital loss could not offset the ordinary income recognized when the property was distributed. While the acceleration of taxes on in-kind distributions under the proposed legislation has received far less publicity than the conversion of carried interest gains to ordinary income, it would constitute an equally fundamental change in the rules that have heretofore guided general partners and investors.

D. A disposition of a carried interest (including many gifts and otherwise tax free transfers and restructurings) would require recognition of any gain or loss in the carried interest (calculated by reference to fair market value, not liquidation value), which would generally be treated as ordinary income or ordinary loss.

E. The Levin Bill does not appear to impact whether non-U.S. carried interest holders are subject to U.S. tax on their carried interests (in contrast to the Rangel Bill, which generally would subject non-U.S. carry participants to U.S. tax if and to the extent the non-U.S. participant or the general partner performed services in the United States).[7] *The Administration Proposal appears generally to follow the Levin Bill approach, but the General Explanation does not provide sufficient details to be certain how the Administration Proposal will address these issues.*

III. Effective Date and "Grandfathering" Rules

A. The Levin Bill does not propose an effective date. *The Administration Proposal would tax carried interest as ordinary income beginning in 2011*.

B. The Levin Bill (like the Rangel Bill) generally would apply to new and existing partnerships, with no exception or "grandfathering" for allocations with respect to existing carried interest arrangements. *The Administration Proposal also does not mention any grandfathering of existing arrangements*.

[7] Under current law, the U.S. taxation, if any, of a non-U.S. individual's carried interest depends on the character of the fund's profits. Thus, for example, the non U.S. individual's share of non-real estate capital gains, many types of interest, and dividends from non-U.S. companies generally is exempt from U.S. tax; whereas the individual's share gains from U.S. real estate and investments in operating LLCs and dividends from U.S. companies generally would be subject to U.S. tax. The U.S. tax issues presented to non-U.S. private equity funds are beyond the scope of this memorandum.

IV. Carried Interests Covered by the Proposed Rules

All of the proposals introduced in Congress target sponsors who received their carried interest in exchange for providing management services to investment funds such as private equity funds, venture capital funds, mezzanine funds, real estate funds, and hedge funds, though, as drafted, they would apply to many other partnerships as well (see Part VIII below).

The Levin Bill recharacterizes a carried interest in a partnership as ordinary income only if the carried interest is an "investment services partnership interest." Subject only to the exception for certain "qualified capital interests," an "investment services partnership interest" includes any interest in a partnership that is held by any person if it was reasonably expected (at the time that such person acquired such interest) that such person (or any person related to such person) would provide (directly or indirectly) a substantial quantity of any of the following services:

A. Advising as to the advisability of investing in, purchasing, or selling any specified asset.

B. Managing, acquiring, or disposing of any specified asset.

C. Arranging financing with respect to acquiring specified assets.

D. Any activity in support of any service described in subparagraphs (A) through (C).

"Specified assets" include securities, real estate held for rental or investment, interests in partnerships, commodities, or options or derivative contracts with respect to any of the foregoing. Presumably, the advisory management services must be provided to or on behalf of the partnership that issues the investment services partnership interest, but that requirement is not expressly stated. No guidance is provided as to how one measures whether the expected services are of a "substantial quantity." Also left unclear is whether the investment services partnership interest definition would include a partnership interest received for marketing interests in the partnership issuer.

The most notable feature of the Administration Proposal is its expansion of the category of affected partnership interests to include any "services partnership interest." While the General Explanation does not provide any details as to how the Administration will define a services partnership interest, the proposal appears to apply to all partnership carried interests received for services, regardless of the type of business involved.

V. Exceptions for Capital Interests

The carried interest proposals have all targeted arrangements that could be characterized as compensation for the sponsor's services and have conceded that some exception should be made for the sponsor's investment of its own capital. However, presumably out of concern that sponsors might avoid the new rules by "disguising" their carried interests as capital interests, the exceptions for capital interest have been drafted quite narrowly. If any of the current proposals becomes law, many capital interests that should be exempt likely will not qualify for these exceptions.

Under the Levin Bill, in the case of any portion of an investment services partnership interest that is a "qualified capital interest," the ordinary income conversion rules and other rules would not apply if (i) allocations with respect to the qualified capital interest are made in the same manner as allocations are made with respect to a capital interest held by one or more third-party investors (who do not provide any of the services described in Part IV above) and (ii) the allocations made to such other interest(s) are significant compared to the allocations made to the qualified capital interest. The Levin Bill defines a qualified capital interest to include so much of a partner's interest in the capital of the partnership as is attributable to:

A. Actual cash or property contributions made in exchange for the partnership interest.

B. Amounts of income recognized by the partner in connection with receiving the interest.

C. Amounts of cumulative net income previously allocated to the partner for taxable years to which the Levin Bill would apply.

A qualified capital interest would not include capital contributions funded from the proceeds of a loan or other advance to the service partner made or guaranteed directly or indirectly by any partner or the partnership (or any person related to the foregoing). However, a loan to a service partner from an independent third-party, such as a bank (absent a guaranty by another partner or the partnership), would not preclude capital gain treatment. In addition, if a non-service partner makes a loan to the partnership, that loan would be treated as a capital contribution by the non-service partner.[8]

The Administration Proposal also includes an exception from ordinary income treatment for profits attributable to a partner's invested capital, based on a reasonable allocation of income and loss between the invested capital interest and the carried interests. While the General Explanation does not describe the invested capital exception in detail, the Rangel Bill also relies on the concept of a "reasonable allocation" to distinguish profits attributable to the carried interest (and treated as ordinary income) from profits attributable to invested capital (and exempt from the new rules), leading one to speculate that the Administration Proposal might adopt the Rangel Bill approach to invested capital. If the Administration Proposal follows the Rangel Bill on that point, then an allocation of income to invested capital would be deemed unreasonable if the allocation would result in the partnership allocating a greater portion of income to invested capital than any other partner not providing services would have been allocated with respect to the same amount of invested capital. In addition, if the Administration Proposal follows the Rangel Bill's definition of invested capital, invested capital would not

[8] Unlike the provisions of the Rangel Bill, the Levin Bill would generally not disqualify an otherwise qualified capital interest held by a service partner who does not also make such a loan, as long as the allocations made with respect to the putative qualified interest are still made in the same manner as allocations made to other significant non-service, non-lending partner(s).

include amounts recognized by the sponsor in connection with receiving a carried interest or allocations to the sponsor of net income that is retained by the partnership.

Many common arrangements have the potential to prevent a capital interest from qualifying as a qualified capital interest under the carried interest proposals. As a result, all or a significant portion of many sponsors' non-carried interests could become subject to ordinary income taxation under these proposals as well. Two notable examples are as follows:

The Levin Bill would appear to cause an otherwise qualified capital interest of a sponsor to be disqualified entirely if the sponsor does not pay the same management fees and promote as at least one other significant investor in the fund. The Rangel Bill, on the other hand (and thus the Administration Proposal if it follows the Rangel Bill on this point), does not appear to disqualify the sponsor's capital interest entirely, but would appear to apply the legislation's ordinary income recharacterization to the amount of income and gain allocated to the sponsor that would have been reduced by management fees or promote if the sponsor in fact had been required to pay such amounts.[9]

The practice of utilizing a waiver of management fees by the sponsor to fund the sponsor's capital commitment would also be impacted by the carried interest proposals. First, the special allocations of gain that sponsors receive in lieu of waived management fees (in order for the sponsor to be permitted to "share" in the subsequent distribution upon return of the fund's invested capital) would be treated as carried interest. Second, such arrangements would prevent the sponsor's capital interest from qualifying as a qualified capital interest to the extent that the special "matching" allocations were made prior to taxable years to which the Levin Bill did not apply. "Matching" allocations made in years after the Levin Bill took effect may qualify as a qualified capital interest, but the Levin Bill is unclear on this point. The Rangel Bill, on the other hand (and thus the Administration Proposal if it follows the Rangel Bill on this point), appears to disqualify a sponsor's capital interest entirely, including both the waived fee and any gain earned on capital contributions funded with the waived fees, to the extent that the capital interest was funded via a waiver of management fees.

VI. Similar Rules for "Disqualified" Carried Interests in Other Entities

Following the introduction of the first Rangel bill, tax practitioners were quick to point out that funds generating income that is free of U.S. tax in the hands of non-U.S. persons (e.g., gains from investments in non-real estate corporations) could potentially avoid the proposed carried interest rules by organizing as an offshore corporation in a low-tax jurisdiction.[10] To prevent these types of perceived abuses, the second generation of carried interest proposals would extend ordinary income treatment to any income or gain with respect to stock and other carried-interest equivalents (referred to as "disqualified interests") held by investment managers in offshore corporations unless the foreign corporation is subject to a comprehensive foreign income tax (or

9 Query how one applies the requirement to charge promote on the sponsor's capital when the same sponsor entity holds both the sponsor's general partner interest and the sponsor's limited partner interest or if the sponsor makes its capital commitment in its capacity as general partner.

10 The attractiveness of such offshore structures is probably overrated. We could discuss their pros and cons as part of a larger discussion of potential responses to the legislation.

subject to U.S. tax with respect to substantially all of its income as result of engaging in a U.S. trade or business).

The Levin Bill provides that a foreign corporation would meet the comprehensive foreign income tax requirement if the corporation is eligible for treaty benefits under a comprehensive income tax treaty with the United States. The Levin Bill would authorize Treasury to extend the disqualified interest rules to apply to S corporations, but Treasury would not have the authority to extend the rules to REITs or RICs.

Notwithstanding that the Levin Bill uses eligibility for treaty benefits as a proxy for determining when a foreign corporation is subject to foreign tax and thus exempt from the disqualified interest rules, eligibility for treaty benefits does not necessarily mean a foreign corporation would pay significant local tax on its private equity investments. We can imagine that the ultimate legislation might focus instead on actual taxes payable, rather than on treaty eligibility. We also have some concern that Treasury might issue regulations limiting the foreign corporation's ability to take advantage of this exception if the corporation is not actually subject to tax in its country of residence. There is precedent for issuing such regulations under similar statutory language.[11]

The Administration Proposal would apply the disqualified interest rules to any service provider who holds a disqualified interest, not just providers of investment management services. The Administration Proposal defines a disqualified interest as an interest in any corporation, other than "certain taxable corporations," without further elaboration.

The disqualified interest rules may become irrelevant for all but the small U.S. sponsored private equity funds if anti-tax haven legislation proposed by Senator Carl Levin (D. MI) becomes law. Under that legislation, a U.S. managed entity organized as a foreign corporation with $50 million or more of gross assets would be treated as a taxable domestic corporation. President Obama supported similar legislation when in the Senate. *However, no such proposal is included in the General Explanation.*

Sponsors interested in offshore structures (or REIT or S corporation structures) should be aware that, among the many issues with such structures, the receipt of a carried interest in a fund organized as a corporation is taxable to the sponsor (generally at the time of receipt) to the extent that the then fair market value of the carried interest exceeds any amount paid for the carried interest. The rules allowing carried interests in partnerships to be valued based on their liquidation value do not apply to interests in corporations (sometimes referred to as the "cheap stock" problem).

---

[11] Code section 457A, which targets deferred compensation arrangements entered into by certain investment fund sponsors, also defines "subject to a comprehensive foreign income tax" as being eligible for treaty benefits. IRS Notice 2009-8, however, limits the ability of a foreign corporation to qualify under that rule for purposes of Code section 457A if the foreign corporation is not actually subject to tax (at no less than 50% of the generally applicable rates) on certain income. The Levin Bill includes a grant of authority to issue regulations to prevent avoidance of the bill, which might be sufficient authority for adopting similar approach for purposes of the disqualified interest rules, particularly given the common aim of carried interest legislation and Code Section 457A.

VII. Anti-Avoidance and Enhanced Penalties

The Levin Bill would direct the Treasury Secretary to prescribe regulations to prevent avoidance of the purposes of the bill. This is a broad grant of power, and in similar circumstances, where the Treasury Secretary has been given such a grant, the regulations prescribed often have been disconcertingly vague.

The Levin Bill would double the penalty (to 40%) for underpayments of tax due to a violation of the "disqualified interest" rules described above or the anti-avoidance regulations, to be prescribed. The Levin Bill would eliminate the "reasonable cause" exception for underpayment penalties, resulting in a strict liability standard for purposes of imposing the enhanced penalties and creating a significant compliance burden on the sponsor.

The Rangel Bill also included enhanced penalties and a broad grant of regulatory authority, so we would not be surprised to see similar provisions included in the Administration Proposal as further details emerge.

VIII. Portfolio Company Concerns

Despite the Levin Bill's focus on carried interests in the private fund context, applied literally its definition of "investment services partnership interest" could reach far beyond the investment fund industry and pick up many businesses whose ordinary operations, whether technology, manufacturing, consumer products, etc., include substantial amounts of cash management, hedging or oversight of subsidiaries. Examples of portfolio companies whose structures may be at risk include:

A. Carried interests to management in an LLC holdco set up to purchase a portfolio company.

B. Management carried interests in an operating LLC that has any corporate or partnership subsidiaries or that manages significant cash reserves.

C. Management carried interests in investment advisory, trading, finance, loan origination, advisory or servicing, or similar businesses organized as LLCs.

D. Carried interests for developer partners or local operating partners in single asset real estate joint ventures.

The Administration Proposal has much broader ramifications because it would apply to all profits interests granted to service providers. If the Administration Proposal becomes law, every structure involving profits interests granted to individuals or companies who provide what could arguably be viewed as services should be re-evaluated. In some cases, management may prefer a corporate structure over a profits interest governed by the new regime and might even benefit from restructuring existing partnership arrangements into corporate structures before the legislation takes effect.

IX. Potential Responses to Carried Interest Proposals

Commentators and practitioners have proposed many ways to avoid the effect of the various proposals. Many of these have prompted responses in the successive legislative efforts that have cut off potential avenues of relief. Moreover, at least in the current political climate, we are concerned that Congress and/or the Treasury might move quickly to shut down any structures that are perceived as exploiting loopholes in any carried interest legislation that is enacted. Nonetheless, at least for sponsors willing to take on the "cheap stock" problem discussed in Part VI above and/or to renegotiate the traditional economic deal with their investors, some structures with comparable economics could potentially survive the enactment of any eventual legislation. We would welcome the opportunity to discuss them with you in detail. Sponsors should also consider the potential impact of the proposed rules on their gift planning and the potential benefits of accelerating the recognition of built-in gains in existing carried interests before the new rules became effective. Any response or potential solution will necessarily have to be tailored to the needs of the specific investors involved, the nature of the investments, the sponsor's economic arrangement with investors, and the sponsor's individual tax situation.

***   *   *   ***

While carried interest legislation appears increasingly likely to be enacted in the near future, it is not yet a foregone conclusion. The final form of any potential carried interest legislation is also not yet clear. We expect industry representatives will continue to work to protect the current tax treatment of carried interests, and perhaps they will ultimately prevail. We will continue to monitor the legislative process and consider potential structural alternatives that might not fall within the scope of the legislation. We would be happy to meet with you to discuss any aspect of the carried interest proposals and their potential impact on your organization at your convenience.