WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

RECENT PROPOSED LEGISLATION REFINES PROPOSALS TO TAX-CARRIED INTEREST EARNED BY MANAGERS OF PRIVATE EQUITY, HEDGE FUNDS, REAL ESTATE AND OTHER INVESTMENT FUNDS AT ORDINARY INCOME RATES

Last month, Congressman Charles Rangel (D-NY), Chairman of the House Ways and Means Committee, introduced a wide-ranging tax reform proposal (the Tax Reduction and Reform Act of 2007) (the "Rangel Bill") containing a number of "revenue raisers," including a provision that would change the tax treatment of sponsors of investment partnerships (including private equity, real estate, venture capital and hedge funds) that receive a share of partnership profit for services performed for the partnership. The right to receive such profit is commonly called a "carried interest." The Rangel Bill would tax amounts recognized in respect of such interest as ordinary income (currently subject to a maximum rate of 35%) rather than long-term capital gain (currently subject to a maximum rate of 15% in the case of individuals) even if derived from the sale of a capital asset. The legislation refines and tightens in several respects an earlier proposal of Congressman Sander Levin (D-MI) (the "Levin Bill").

It is unlikely that the Rangel Bill will be enacted in whole this year, although it is conceivable that some of the revenue raisers contained in the bill might be enacted as an offset to any "patch" addressing the alternative minimum tax. If the Rangel Bill, or at least the revenue-raising portions, were enacted next year, it is possible that the proposed November 1, 2007 effective date for the carried interest provision (discussed at the end of this memo) might be retained.

Under current law, a partnership's income and gain, including long-term capital gain, retains its character when allocated to its partners, even if the allocation is received for services. Gain on the sale of a partnership interest is generally taxed as capital gain. The legislation would generally treat net income allocated in respect of an "investment services partnership interest," and gain from the sale of such an interest, as ordinary income received for the performance of services. Net losses with respect to such an interest would be allowed only to the extent of prior net income less previously allowed losses. The provision would not change the timing of the income and gain recognition or affect the tax treatment of the other partners.

Like the Levin Bill, the Rangel Bill broadly defines an "investment services partnership interest" as any interest in a partnership held by a person that directly or indirectly provides, in the active conduct of a trade or business, a substantial quantity of any of the following services to the partnership: advising the partnership as to the value of a specified asset or the advisability of investing in, purchasing or selling a specified asset; managing, acquiring or disposing of a specified asset; arranging financing with respect to acquiring specified assets; and performing activities supporting the foregoing. It defines "specified assets" as securities (generally stock, debt and interests in widely held or publicly traded partnerships or trusts but not other types of partnerships or trusts), real estate, commodities and options or derivatives with respect to those assets. Therefore, the Rangel Bill would not change the taxation of a carried interest or other allocation received for services provided to many kinds of operating partnerships.

Also, as with the Levin Bill, the Rangel Bill includes an explicit exception for partnership interests acquired for a contribution of invested capital, but only if there is a reasonable allocation between the partner's share with respect to the invested capital and the share attributable to services. For this purpose, an allocation is not reasonable if it results in an allocation of more income to the invested capital than any other partner not providing services would have been allocated for the same amount of invested capital.

In addition, the Rangel Bill addresses two structures that had been publicly suggested as possible means of avoiding the provisions of the Levin Bill. First, it had been suggested that the exception for interests acquired for a contribution of capital could be availed of through an arrangement in which the carried interest partner borrows funds from the partnership or other partners and then contributes the borrowed proceeds as a capital contribution. The Rangel Bill provides that the exception for interests attributable to invested capital will not apply to capital attributable to loans made or guaranteed by another partner or the partnership. Second, it had been suggested that the investment fund could be organized as a foreign corporation qualifying as a passive foreign investment company (a "PFIC") (similar to most offshore hedge funds). An interest in the PFIC that replicates a carried interest could be granted and capital gains could be passed through to the manager by means of the so-called "QEF election." The Rangel Bill defeats this structure by extending ordinary income treatment to a person who performs investment management services for an entity if the person holds a "disqualified interest" in the entity. A "disqualified interest" is defined to include equity interests in an entity other than a taxable corporation (defined as a domestic C corporation or a foreign corporation subject to a "comprehensive foreign income tax"), as well as options, convertible debt instruments and derivatives with respect to such entities. However, the Rangel Bill does not change the tax treatment of stock (including deeply subordinated stock that functions economically like a carried interest) in a taxable corporation received for services. This may be because, depending on the circumstances, recharacterizing such income as compensation could actually lower total taxes paid when the income results in a corresponding compensation deduction to the corporation.

To discourage aggressive attempts to circumvent the proposal, the Rangel Bill adds a broad grant of authority to the IRS to prescribe regulations as necessary or appropriate to prevent the avoidance of the provisions, steps up the penalty on tax understatements related to the provision to 40% (rather than the usual 20%) and provides that the reasonable-cause exception to the understatement penalty is not available.

In addition to affecting the applicable rate of tax, the recharacterization of income and gain under the bill would have other potential consequences to many different types of taxpayers and transactions. Some of these consequences are clearly intended; others are not.

- *Qualifying income under the publicly traded partnership rules.* The Rangel and Levin Bills, like the so-called Blackstone Bill previously introduced in the Senate, seek to prevent publicly traded partnerships engaging in an investment advisory business from being taxed as partnerships. However, while the Senate bill would preclude partnership treatment if any income is derived from these services, the Rangel and Levin Bills would simply treat this income as nonqualifying under the test that requires 90% of the partnership's income to be qualifying income for partnership treatment to be available to a publicly traded partnership.

- *U.S. trade or business income*. Although not explicitly stated, the Rangel Bill also appears to treat income recharacterized under the measure as subject to regular net-based U.S. federal income taxation to the extent allocable to foreign investors, assuming the relevant services are performed in the United States. Under current law, foreign investors in a partnership are generally not subject to U.S. taxation on their share of the partnership's capital gain, non-U.S. source income and certain types of U.S.-source interest income. If enacted, the bill would likely discourage non-U.S. persons from investing in advisory businesses that receive a carried interest, limiting this increasingly common source of capital for these businesses.
- *Unrelated business taxable income*. It is unclear whether the Rangel Bill is also intended to treat income and gain recharacterized under the provision as unrelated business taxable income ("UBTI") and thus subject to tax in the hands of otherwise tax-exempt investors. Most investment income, unless debt-financed, is not UBTI. Again, such a provision likely would discourage tax-exempt investors from investing in advisory businesses that receive a carried interest.
- *Investment vehicles with subordinated and preferred partnership interests*. Many investment vehicles are structured as partnerships with preferred and subordinated interests, where some members provide advisory-like services to the partnership (for example, family investment partnerships and trusts designed to create short-term municipal paper). The intended and actual effect of the legislation on these structures is unclear, but its provisions would seem potentially applicable if a member provides substantial services as part of an active trade or business.

The Rangel Bill does not recharacterize income and gain for purposes of determining whether a fund meets the requirements for qualifying as a real estate investment trust (a "REIT"). However, any recharacterized income would be treated as ordinary income to the REIT shareholders when distributed to them.

Finally, any income or gain recharacterized under the Rangel Bill would be subject to the 2.90% Medicare tax, which is uncapped, as well as the 12.40% Old Age, Survivors and Disability Insurance tax (also known as the Social Security tax), which is capped at $12,090. Under current law, this income generally is not subject to these employment taxes.

The provisions are proposed to be effective for taxable years ending after November 1, 2007, with an allocation between the pre- and post-November 1 portions of the taxable year that includes November 1, 2007. The proposal does not distinguish between partnerships created before or after November 1, 2007, nor does it grandfather appreciation that already has economically accrued. Accordingly, as currently drafted, capital gains allocated next year to a partnership interest granted years ago could be subjected to the provisions of the legislation. It is possible that the final bill might incorporate some kind of transitional relief for existing partnerships and properties, but that might be difficult to administer for assets that are not publicly traded.

The provisions relating to publicly traded partnerships are effective after December 31, 2009.

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