

DAVIS POLK & WARDWELL

Date: April 13, 2009
To: Interested Persons
Re: **Update on “Carried Interest” Legislation: New Levin Bill**

President Obama’s budget proposal, released on February 26, 2009, contained the following line item: “Tax carried interest as ordinary income.” On April 3, Representative Sander Levin (D-Mich.) re-introduced legislation (the “New Levin Bill”) to treat income derived from a sponsor’s “carried interest” or “incentive allocation” in an investment partnership as ordinary income and to subject that income to self-employment tax. In comments released with the bill, Representative Levin rejected various arguments that have been raised against changes to the taxation of “carried interest” allocations, including the argument that fund managers are similar to entrepreneurs who receive founders’ stock in their companies.

Representative Levin’s proposed legislation also addresses the treatment of publicly traded partnerships, such as Blackstone Group, that receive “carried interest” allocations; the treatment of sales of interests in partnerships that hold depreciable or amortizable property, including transactions involving tax sharing agreements; and the treatment of the receipt of a profits interest in a partnership in exchange for services.

The provisions of the New Levin Bill with respect to “carried interest” are substantially the same as the corresponding provisions contained in a bill originally proposed by Representative Charles B. Rangel (D-N.Y.) in October 2007 (the “Rangel Bill”) and passed by the House of Representatives in November 2007 and June 2008. Like the Rangel Bill, the New Levin Bill would specifically disallow certain structures that have been discussed by tax advisors as possible responses to the proposed legislation, would direct the Treasury Department to promulgate anti-avoidance regulations and would provide for heightened penalties for failure to comply. While the few changes from the Rangel Bill generally serve to broaden slightly the application of the proposed legislation, several of the provisions of the New Levin Bill are unclear and their impact is uncertain.

This memorandum provides a summary of the provisions of the New Levin Bill. We shall continue to monitor developments and to consider planning opportunities.

Ordinary Treatment of “Carried Interest” Allocations

Under current law, the character of the income, gains, losses and deductions recognized by a partnership flows through to the partners. The proposed legislation would override this flow-through treatment in the case of an “investment services partnership interest.” Under the New Levin Bill, net income or net loss allocated by a partnership in respect an “investment services partnership interest,” and each item of income, gain, loss and deduction included in the computation of such net income or net loss, would be treated as ordinary income or ordinary loss.¹ Like the Rangel Bill, the new proposal would limit the amount of net loss allocations that the holder may claim in respect of an “investment services partnership interest” to the amount of net income that the holder has included in respect of the interest.

An interest in a partnership will be an “investment services partnership interest” if it was reasonably expected, at the time that the holder acquired the interest, that the holder, or any person related to the holder, would provide, directly or indirectly, a substantial quantity of advisory or management services with respect to securities, real estate held for rental or investment, interests in partnerships, commodities, or options or other derivative contracts with respect to any of these types of assets (such services, “Investment Management Services”). While the Rangel Bill contained a similar definition, the New Levin adds the provision under which Investment Management Services performed by a related person will cause the holder’s profits interest to be treated as an “investment services partnership interest.” This provision may apply, for example, to the common situation in which profits interests are held by fund managers’ family investment vehicles or estate-planning vehicles. In addition, the New Levin Bill removes the Rangel Bill’s requirement that the Investment Management Services be performed in the conduct of the trade or business of providing such services,

¹ Unlike the Rangel Bill, the New Levin Bill would characterize income allocations in respect of an “investment services partnership interest” simply as ordinary income, rather than as ordinary income for the performance of services. In addition, the New Levin Bill eliminates the Rangel Bill’s requirement that the services performed in connection with an “investment services partnership interest” constitute part of the conduct of a trade or business. The general partner of an investment partnership, or other entity entitled to receive “carried interest” allocations from an investment partnership, is often itself an entity that is treated as a partnership for tax purposes (a “Carry Plan Partnership”). While the members of a Carry Plan Partnership are generally the portfolio managers of the underlying fund, some Carry Plan Partnerships grant interests to members who are not providing investment services to the fund, such as lead investors in the fund. The foregoing changes could conceivably serve to mitigate potential adverse consequences for members of Carry Plan Partnerships that provide their services outside the United States, as well as for members of Carry Plan Partnerships, including non-U.S. members and tax-exempt members, that are not providing services. There are numerous uncertainties, however, with respect to the application of the proposed legislation to non-U.S. and tax-exempt members of Carry Plan Partnerships.

thus eliminating the necessity of determining whether specific services would constitute the conduct of a trade or business under common law principles.

Self-Employment Tax

Any income or loss of an individual that is treated as ordinary under the New Levin Bill would be taken into account in determining the individual's "net earnings from self-employment," which is subject to U.S. federal self-employment tax. As a result, any net income that is treated as ordinary under the bill would be subject to the 2.9% Medicare hospital insurance tax, in addition to being subject to tax at ordinary income rates.² The proposed provision would, however, permit the individual to use his or her share of losses with respect to an "investment services partnership interest" to offset other earnings from self-employment.

Ordinary Treatment for Dispositions of Interests and Distributions in Respect of Interests

The New Levin Bill would treat as ordinary income not only allocations of partnership profits made in respect of an "investment services partnership interest," but also gain derived from the disposition of an "investment services partnership interest." In addition, if a partnership, such as a fund manager's family partnership, held an "investment services partnership interest," a sale of an interest in the upper-tier partnership would be treated as a sale of the underlying "investment services partnership interest" to the extent that the consideration received was attributable to that underlying interest. Under current law, a partner that receives a distribution of cash from a partnership recognizes gain to the extent that the cash exceeds the basis of the partner's interest in the partnership, and this gain is treated as derived from the sale or exchange of the partnership interest. Any such gain with respect to an "investment services partnership interest" would apparently be treated as ordinary under the New Levin Bill.

While the Rangel Bill contained a similar provision, the New Levin Bill would also require the holder of an "investment services partnership interest" to recognize gain on the disposition of the interest even if the disposition would otherwise have been subject to a non-recognition provision. As a consequence, for example, ordinary income could be recognized in connection with the contribution of an "investment services partnership interest" to a family

² Net income that is treated as ordinary under the New Levin Bill would also be taken into account for purposes of the 12.4% old-age, survivors and disability insurance tax, but this tax not imposed on any self-employment income that exceeds an annual base amount, which is \$106,800 for 2009.

partnership or, presumably, in connection with the transfer of such an interest by gift.

The New Levin Bill also provides that a partner who receives a distribution of appreciated property in respect of any “investment services partnership interest” will be treated as receiving an allocation of ordinary income in an amount equal to the gain that the partnership would have recognized on a sale of the property, except to the extent that the partnership otherwise takes this gain into account in determining its taxable income. This provision differs from the comparable provision in the Rangel Bill by specially allocating to the distributee partner the portion of the gain recognized by reason of the proposed legislation. In addition, any in-kind distribution of property in respect of an “investment services partnership interest” would be treated as a distribution of money, and would thus cause the distributee partner to realize additional income to the extent that the fair market value of the property exceeded the partner’s basis in the “investment services partnership interest.”

Exception for Qualified Capital Interest

The New Levin Bill would not apply to the portion of a partner’s interest that constitutes a “qualified capital interest,” provided that the partnership’s allocations of income, gains, losses and deductions meet certain requirements. As a result, partnership items (*e.g.*, capital gains) that are allocated to such a “qualified capital interest” would be characterized under a flow-through approach. The provisions with respect to “qualified capital interests” are unclear in various respects, however. For example, where a “qualified capital interest” is a portion of a larger partnership interest, the New Levin Bill does not provide any explanation of how to determine the amount of allocations that will be treated as made to the “qualified capital interest.” The exception for a partner’s “qualified capital interest” would apply only if (i) the partnership makes allocations to such “qualified capital interest” in the same manner as it makes allocations to capital interests held by unrelated partners who do not provide Investment Management Services and (ii) the allocations made to those other interests are significant in comparison with the allocations made to the such “qualified capital interest.” The New Levin Bill does not define or otherwise explain how a partnership would make allocations “in the same manner” to capital interests held by service-providing partners and other partners, nor does it define a “significant” allocation.

A “qualified capital interest” is the portion of a partner’s interest that is attributable to (i) the contribution of money or other property to the partnership, (ii) the inclusion of compensation income upon the grant of the interest and (iii) the allocation of undistributed net income in respect of the interest. While the Rangel Bill contained a similar provision, it applied only to the portion of a partnership interest acquired in exchange for the contribution of money or other property.

A partnership interest would not be treated as a “qualified capital interest” to the extent that it was acquired “in connection with” the proceeds of any loan or other advance made or guaranteed, directly or indirectly, by any partner or by the partnership, or by any person related to any partner or the partnership. Thus, for example, a partner providing Investment Management Services could not receive flow-through treatment with respect to allocations made in respect of an interest in the partnership that the partner acquired with the proceeds of a loan made by other partners, regardless of whether the lender had recourse to the borrower partner’s other assets. Moreover, loans or other advances to the partnership that are made or guaranteed, directly or indirectly, by a partner that does not provide Investment Management Services, or by any person related to such a partner, would be treated as invested capital of that partner for purposes of applying the exception for “qualified capital interests.” The precise effect of this provision is unclear, but presumably it is intended to reduce the percentage of allocations that are treated as made to a “qualified capital interest” held by a partner that provides Investment Management Services.³ Although the Rangel Bill contained substantially identical rules, the New Levin Bill broadens to some extent the scope of their application, principally by adding the provisions with respect to related persons.

Financial Instruments Other Than Partnership Interests

Like the Rangel Bill, the New Levin Bill would apply rules similar to the foregoing rules to any income or gain derived from a “disqualified interest” with respect to an entity if (i) the holder of the interest performs Investment Management Services, directly or indirectly, for the entity and (ii) the value of the interest (or the payment stream under the interest) is substantially related to the amount of realized or unrealized income or gain derived from the managed assets. “Disqualified interests” include equity interests in certain entities, convertible or contingent debt, options and derivative instruments. The term excludes partnership interests, stock in “taxable corporations” and, except as may be provided in Treasury regulations, stock in S corporations. For this purpose, a “taxable corporation” is defined as either (i) a domestic C corporation or (ii) a foreign corporation substantially all of the income of which is either effectively

³ Suppose, for example, that a private equity fund is capitalized with \$5x of common equity of which the general partner contributes \$1x, or 20%, and that the limited partners make loans to the partnership of \$95x. Suppose further that the fund’s partnership agreement provides that, after repayment of the loans, the partnership will allocate its income *pro rata* in accordance with capital contributions – that is, 20% to the general partner and 80% to the limited partners. Presumably, under the proposed provision, only 1% of the partnership’s allocations would be treated as made to the general partner’s “qualified capital interest,” although this result is not clear under the statutory language.

connected with the conduct of a trade or business in the United States or subject to a comprehensive foreign income tax. Stock in a “passive foreign investment company” organized in a tax haven jurisdiction would thus constitute a “disqualified interest” to which the proposed legislation would apply.

Penalties

In the case of any underpayment of the tax attributable to the “disqualified interests” discussed in the preceding paragraph, the taxpayer would be subject to a special penalty equal to 40% of the amount of the underpayment. This heightened penalty would also apply to any underpayment of tax that is attributable to the application of Treasury regulations promulgated, pursuant to the direction of the proposed legislation, to prevent the avoidance of the new provisions. Remarkably, no “reasonable cause” exception to these penalties would be available to the taxpayer. Conceivably, the severity of this provision might be mitigated in the course of the legislative process, but there can be no assurance that any favorable change will be made.

Other Provisions of the New Levin Bill

Publicly Traded Fund Managers

Under current law, a publicly traded partnership is generally treated as a corporation for U.S. federal income tax purposes unless at least 90% of its gross income for each taxable year consists of “qualifying income,” which includes most types of investment income. Under the New Levin Bill, income and gain with respect to “investment services partnership interests” that is treated as ordinary income pursuant to the provisions described above would generally not constitute “qualifying income.”⁴ This provision is directed at entities such as Fortress Investment Group and Blackstone Group, which are publicly traded partnerships that receive “carried interest” allocations from investment partnerships. The new exclusion from “qualifying income” would not apply, however, to any existing publicly traded partnership for ten years after the date of enactment.

Tax Receivables Agreements

Under current law, gain recognized on the sale of property to a related person is treated as ordinary income if the transferred property is subject to depreciation or amortization in the hands of the purchaser. The New Levin Bill

⁴ Exceptions would apply to the partnerships in certain “UPREIT” structures and to partnerships that hold interests in certain lower-tier partnerships that generate business income.

contains a provision, also contained in the Rangel Bill, that would (i) apply this rule to the sale of a partnership interest to the extent that the gain is attributable to depreciable or amortizable property held by the partnership and (ii) treat the seller and purchaser as related persons if there is a “tax sharing agreement” with respect to the sale under which the purchaser makes payments to the seller equal to a portion of the benefits that the purchaser derives from claiming depreciation or amortization deductions. Agreements of this type have been included in a number of initial public offerings in recent years.

Receipt of Partnership Profits Interests for Services

The New Levin Bill would codify the current position of the Internal Revenue Service with respect to the tax consequences of the receipt of a partnership profits interest in connection with the performance of services for, or on behalf of, the partnership. While these rules generally prevent a partner from realizing compensation income upon the receipt of a partnership profits interest, their effect under the New Levin Bill would also be to prevent any portion of the interest from being treated as a “qualified capital interest” to which flow-through treatment would apply.

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