ABA TAX SECTION

PLANNING FOR AND REVIEW OF PROPOSED CHANGES TO TAXATION OF CARRIED INTERESTS

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Washington, D.C.
May 9, 2008

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I. OVERVIEW OF TAXATION OF CARRIED INTERESTS UNDER CURRENT LAW

A. DEFINITION OF CARRIED INTEREST. The term "carried interest" is not defined in the Internal Revenue Code (the "Code") or the Treasury Regulations promulgated under the Code.[2] A carried interest generally refers to an interest in partnership profits that a general partner or manager receives in exchange for services. In addition to its carried interest, a general partner or manager may invest capital in a partnership along with other investors. As commonly used, the term "carried interest" refers to a share in profits beyond that returned to the general partner or manager for equity it invests in the partnership.

> EXAMPLE: A, B and C form the ABC Partnership. A is the sole general partner and also contributes $1,000 for a 1% limited partnership interest. B and C each contribute $49,500 for a 49.5% limited partnership interest. The ABC Partnership agreement provides that distributions are made in the following order and priority. First, to the limited partners (including A to the extent of its limited partnership interest) until the limited partners have received a 7% preferred return. Second, to the limited partners (including A to the extent of its limited partnership interest) until they have recovered their capital contributions. Third, 80% to the limited partners and 20% to the general partner. The general partner's carried interest consists of its 20% interest in distributions after the limited partners have received their preferred return and capital contributions.

Carried interests come in a variety of different forms. The example above illustrates only one form of carried interest.

B. TAXATION OF PROFITS INTERESTS ISSUED FOR SERVICES.

1. Capital vs. Profits Interest. Current guidance in the form of Rev. Proc. 1993-27, 1993-2 C.B. 343, as well as some of the cases discussed below, distinguishes the issuance of a profits interest from the issuance of a capital interest in exchange for services. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in complete liquidation of the partnership. A profits interest is any interest that is not a capital interest. The

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[2] Unless otherwise indicated, all "Section" references are to the Code.

determination as to whether an interest is a capital interest generally is made at the time of receipt of the partnership interest.[3]

2. Taxation of Carried Interests. Carried interests generally are intended to be treated as profits interests. As discussed in more detail below, under current law, generally no income is recognized by the service provider or the partnership on the issuance or vesting of a profits interest in a partnership. The profits interest is treated as a distributive share of partnership income. Accordingly, the character of income allocated to the holder of a profits interest passes through to the holder of a profits interest. The partnership is not entitled to claim a deduction for payments made with respect to the carried interest. However, the income and profits allocated to the holder of a profits interest reduce the amount of income or profits allocated to the other partners.

3. Comparison to Corporate Context. The income tax consequences of the issuance of corporate stock (or other property) for services are generally determined under Section 83 of the Code. Under Section 83, if a corporation issues stock in exchange for services, the recipient recognizes ordinary income on the later of (i) the date the stock is received or (ii) the first date on which the stock is either transferable or is not subject to a substantial risk of forfeiture. Appreciation occurring after the date this income is recognized is taxed at the time the employee disposes of the stock and generally will qualify as capital gain. A recipient can make an election under Section 83(b) to disregard a substantial risk of forfeiture and recognize income at the time stock is received. A Section 83(b) election may be beneficial if the recipient believes that the stock will appreciate significantly in value prior to vesting. Although a Section 83(b) election accelerates the time at which the recipient would otherwise recognize income on the receipt of the stock, it limits the amount of appreciation that is taxed as ordinary income as subsequent appreciation will be taxed as capital gain at the time the recipient sells the stock. A mere unfunded and unsecured promise to pay money in the future is not considered property for purposes of Section 83 and therefore is not subject to Section 83. As discussed below, Section 83 is relevant to the taxation of capital interests and several courts have applied Section 83 to the issuance of profits interests. Apart from recognizing that a Section 83(b) election is not required to avoid characterization of an unvested profits interest as a capital interest at the time the interest becomes vested, Rev. Proc. 93-27 and Rev. Proc. 2001-43 generally do not apply Section 83 in analyzing the issuance of a profits interest.

4. Treas. Reg. § 1.721-1 (1956). Section 721(a) provides that no gain or loss is recognized on the transfer of property to a partnership in exchange for a partnership interest. However, Section 721 does not apply to the extent that any of the partners gives up any part of his right to be repaid his contributions in favor of another partner as compensation for services. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under Section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. Taxpayers

[3] See Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 CB 191.

have attempted to argue that, because Treas. Reg. § 1.721-1 requires recognition of income on receipt of a capital interest, it implies that the receipt of a profits interest in exchange for services is not a taxable event. Courts and the IRS have generally rejected these arguments, holding that Treas. Reg. § 1.721-1 simply is not relevant to the taxation of profits interests issued in exchange for services.

5. Diamond v. Commissioner, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974). In Diamond, the Tax Court held that a taxpayer recognized $40,000 of income on the receipt of a partnership interest in exchange for services provided in obtaining a mortgage loan. The partnership interest entitled the taxpayer to 60% of the earnings and 60% of the losses from the property held by the partnership for 24 years. On liquidation, the taxpayer participated in profits only after the other partners had recovered their invested capital. The partnership interest was not transferable without the consent of the other partner. The taxpayer received the partnership interest in December of 1961 and sold the partnership interest less than 3 weeks later in January of 1962 for $40,000.

a. The Tax Court held that Treas. Reg. § 1.721-1 did not address the issue of whether a taxpayer recognized income on the receipt of a profits interest for services. According to the court, Section 721 did not apply to such a transaction at all.

b. The taxpayer argued in the alternative that the partnership interest had no value at the time it was received. Based primarily on the evidence of the relatively contemporaneous sale, the Tax Court held that the taxpayer was treated as recognizing $40,000 of income at the time the partnership interest was received in 1961.

c. The Seventh Circuit affirmed. The court treated the interest as a profits interest and agreed that Section 721 did not apply to the issuance of a profits interest for services. The court recognized that requiring taxpayers to determine whether a profit share had a determinable value at the time it was issued could create difficulties and indicated that this made promulgation of regulations addressing the issue desirable. However, the court deferred to the expertise of the IRS and affirmed the decision of the Tax Court.

6. St. John v. United States, 54 AFTR 2d 84-718 (C.D. Ill. 1983). The taxpayer received a 15% interest in a partnership in 1975. The court analyzed the partnership interest under Section 83 and found that it was subject to a substantial risk of forfeiture until 1976. The court found that the interest was not a capital interest and that on liquidation the taxpayer would not have received anything until all the other partners recovered their capital. The court found it was appropriate to determine fair market value by using liquidation value in these circumstances and found that the interest had no value at the time it vested in 1976. See also Kenroy v. Commissioner, T.C. Memo. (CCH) 1984-232; Mark IV Pictures v. Commissioner, T.C. Memo. (CCH) 1990-571.

7. Campbell v. Commissioner, T.C.M. 1990-236, rev'd, 943 F.2d 815 (8th Cir. 1991).

a. The Tax Court held that the taxpayer was required to include in income the value of a partnership profits interest received in exchange for services. Mr.

Campbell worked for Summa T Realty and was responsible for identifying suitable properties for his employer to acquire, obtaining necessary financing, organizing partnerships to acquire the properties, and assisting in the preparation of offering materials for the syndication of interests in the partnership. In addition to other compensation, Mr. Campbell received a special limited partnership interest in the partnerships which was characterized as a profits interest for which he was required to contribute $100.

b. The Tax Court refused to overturn its decision in Diamond and held that the regulations under Section 721 did not apply to the issuance of profits interests in exchange for services.

(1) The Tax Court emphasized that, in regard to contributions of property, Section 721 drew no distinction between capital and profits interests.

(2) The Tax Court held that the determination of when Mr. Campbell was required to recognize any income from the receipt of the profits interest was governed by Section 83. The Tax Court also ruled that a profits interest constitutes property for purposes of Section 83 and is not simply an unfunded and unsecured promise to pay money in the future.

(3) The Tax Court stated that it was immaterial whether Mr. Campbell received a profits interest or a capital interest. The Tax Court rejected the argument that the interests Mr. Campbell received had only speculative value as there were contemporary sales of similar, though not identical interest. Specifically, the general partner had purchased an interest with similar rights for approximately $30,000. The court ultimately determined Campbell's interest had a value of $25,000 in 1979.

c. The Eighth Circuit reversed the Tax Court's decision.

(1) The court noted that while prior decisions had clearly held that the receipt of a capital interest in exchange for services was a taxable event, prior cases with respect to the receipt of a profits interest were inconsistent.

(2) The court noted that when a capital interest is received in exchange for services, a capital shift occurs. Because no capital shift occurs when a profits interest is issued for services, there is some basis for distinguishing between capital and profits interests.

(3) The court found Section 707 to be more relevant to the issue than Section 721. The court explained that Section 707(a)(1) treats payments from a partnership to a partner as payments from the partnership to one who is not a partner only if the performance of services and the payment, when viewed together "are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership." The court reasoned that this section would be unnecessary if compensatory transfers of profits interests were always taxable since every such transfer would be taxable without Section 707.

(4) The court found that in Diamond, the taxpayer's services had clearly been rendered in a capacity other than as a partner, but Campbell's case was not so clear. Diamond quickly sold his interests and did not intend to remain a partner. Campbell's interests were not transferable and not likely to produce immediate returns.

(5) Finally, the court agreed that the value of Campbell's interests were speculative. As a result, the court concluded that Campbell's profits interests were without fair market value at the time he received them and should not have been included in income.

C. REV. PROC. 93-27, 1993-2 C.B. 343

1. In Rev. Proc. 93-27, the IRS indicated that the issuance of a "profits interest" to a partner in exchange for services will generally be tax-free to both the partnership and the partner. The profits interest must be received by the partner in his capacity as a partner for this treatment to apply. Thus, Rev. Proc. 93-27 draws a clear distinction between profits interests and capital interests. Rev. Proc. 93-27 recognized three exceptions. Thus, Rev. Proc. 93-27 does not apply:

a. If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;

b. If within two years of receipt, the partner disposes of the profits interest; or

c. If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of section 7704(b).

2. The IRS clarified Rev. Proc. 93-27 in Rev. Proc. 2001-43 by stating that the determination of whether an interest is a profits interest is made at the time the interest is received, even if the interest is substantial non-vested under Section 83 at that time. As a result, where a partnership grants a profits interest to a service provider in a transaction meeting the requirements of Rev. Proc. 93-27 and Rev. Proc. 2001-43, the IRS will not treat the grant of the interest or the event that causes the interest to become substantially vested as a taxable event. Rev. Proc. 2001-43 also states that it is not necessary for a taxpayer to file an election under Section 83(b) to obtain this treatment. However, two conditions must be satisfied:

a. The partnership and the service provider must treat the service provider as the owner of the partnership interest from the date of its grant and the service provider must take into account his or her distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;

b. Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest.

D. SECTION 409A. The American Jobs Creation Act of 2004 (P.L. 108-357; 10/22/2004) added Section 409A to the Code. Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met. In Notice 2005-1, 2005-2 I.R.B. 274, the IRS stated that Section 409A applies to arrangements between a partner and a partnership. However, Notice 2005-1 states that taxpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated under applicable guidance as not resulting in inclusion of income by the service provider at the time of issuance as also not resulting in the deferral of compensation. Similarly, until additional guidance is issued, for purposes of Section 409A, taxpayers may treat an issuance of a capital interest in connection with the performance of services in the same manner as an issuance of stock. To date, proposed and final regulations issued under Section 409A have not addressed these issues. Finally, Section 409A may apply to payments covered by Section 707(a)(1) made to a partner not acting in his capacity as a partner if such payments otherwise would constitute a deferral of compensation under a nonqualified deferred compensation plan.[4]

E. THE PROPOSED REGULATIONS AND NOTICE 2005-43. On May 5, 2005, the IRS released Notice 2005-43[5] and proposed regulations under Section 83[6] that would substantially revise the taxation of the issuance of partnership interests in exchange for services. Briefly, the proposed regulations would provide for the following rules.

1. The transfer of all compensatory partnership interests will be governed by Section 83.

2. There would no longer be a distinction between "profits" interests and "capital" interests. Rev. Procs. 93-27 and 2001-43 would be obsolete once the draft Rev. Proc. contained in Notice 2005-43 is finalized.

3. The partnership generally would recognize no income or loss on the transfer of a compensatory partnership interest.

4. The Proposed Regulations and Notice 2005-43 provide that, if certain requirements are met, the partnership and the service partner can value the compensatory partnership interest based upon its liquidation value.

a. By allowing a liquidation valuation approach, the Proposed Regulations and Notice 2005-43 still allow a "profits" interest to be issued tax-free provided that the partnership and the service partner agree that it has no value upon issuance.

b. The partnership and it partners can elect to comply with a safe harbor under which the value of the compensatory partnership interest will be equal to its liquidation value. This election requires, amongst other things that:

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[4] Notice 2005-1, 2005-2 I.R.B. 274, Q&A-7.
[5] Notice 2005-43, 2005-24 I.R.B. 1221.
[6] Prop. Reg. § 1.83-3(l).

(1) The partnership prepare a document that is executed by a partner that has responsibility for the partnership's tax reporting that provides that the partnership elects to have the safe harbor apply. This document must be attached to the partnership's tax return for the year that the election is effective.

(2) The partnership agreement must contain provisions that are legally binding on all of the partners stating that:

(a) The partnership is authorized and directed to elect the safe harbor, and

(b) The partnership and all of its partners agree to comply with all of the safe harbor requirements as long as the election remains effective.

(3) If the partnership agreement doesn't contain the above provisions, or if these provisions are not legally binding on all of the partners, the partnership may still qualify for the liquidation valuation election if each partner in the partnership that transfers a compensatory partnership interest executes a document that is legally binding on the partner that provides that:

(a) The partnership is authorized and directed to elect the safe harbor, and

(b) The partner agrees to comply with all of the safe harbor requirements as long as the election remains effective.

5. These rules are proposed to be effective on and after the date that the final Regulations are published in the Federal Register. The proposed Rev. Proc. is intended to be finalized and effective in conjunction with the finalization of the Proposed Regulations.

II. PROPOSED LEGISLATIVE CHANGES TO TAXATION OF COMPENSATORY PARTNERSHIP INTERESTS

A. H.R. 2834

1. Applies to an "investment services partnership interest."

a. Taxpayer must (a) "directly or indirectly" (b) in the conduct of a trade or business (c) provide a "substantial quantity of … services" (d) to the partnership in which the person has an interest.

b. The services included (a) advising as to value; (b) advising as to advisability of investing in, purchasing or selling such assets; (c) managing, acquiring or disposing of such assets; (d) arranging financing with respect to acquiring such assets; and (e) any activity in support of the foregoing.

c. Relevant assets are (a) securities, (b) real estate, (c) commodities or (d) options or derivative contracts with respect to the foregoing.

2. As to such interests:

a. Any net income (*i.e.*, the excess of all items of income or gain under section 702(b), over all items of deduction and loss) that is allocated with respect to such interest for any partnership taxable year will be treated as ordinary income for the performance of services;

b. Any net losses are allowed only if they exceed (a) aggregate prior net income allocations over (b) aggregate prior net loss allocations (but disallowed losses may be carried forward to offset future net income allocations);

c. Any gain recognized on the disposition of an investment services partnership interest will be treated as ordinary income for the performance of services; and

d. In the case of any distribution of appreciated property by a partnership with respect to an investment services partnership interest, the partnership will recognize gain in the same manner as if it sold such property at fair market value at the time of distribution.

3. Exception for Invested Capital

a. Taxpayer must have contributed money or other property to the partnership.

b. Exception available only to the extent that partnership makes a reasonable allocation of partnership items between purchased interest and compensatory interest (with presumption of unreasonableness if purchased interest gets greater share of income than other partners on same amount of contributions).

B. H.R. 3996

1. Loss limitation does not apply to basis of partnership interest acquired by purchase (as measured immediately after such purchase).

2. Investment services partnership interest is an inventory item when applying 751(a).

3. Changes to definition of "investment services partnership interest":

a. Eliminates requirement that trade or business must be active.

b. Provision of service no longer modified by "in the … conduct of a trade or business" but the services must be "with respect to the assets of the partnership in the conduct of the trade or business of providing such services."

c. Advising as to value is no longer a "bad" service.

4. Capital attributable to proceeds of loan or advance made or guaranteed, directly or indirectly, by a partner or the partnership cannot be used to convert a compensatory interest to a purchased interest (capital will instead be treated as capital of the lender/guarantor for purposes of testing purchased/compensatory interest allocations).

5. If a person directly or indirectly performs "investment management services" for an entity AND holds a "disqualified interest" with respect to the entity AND the value of the interest (or payments thereunder) is substantially related to income/gain (realized or not) from the assets with respect to which the investment management services are performed, then income/gain is compensation income (with "rules similar to" the rules for purchased interests applying).

a. A "disqualified interest" is (a) any interest other than indebtedness, (b) convertible or contingent debt, (c) an option or right to acquire the foregoing and (d) derivative instruments entered into (directly or indirectly) with the entity or an investor in the entity BUT NOT (x) a partnership interest or (y) stock in a domestic C corporation or foreign corporation subject to a comprehensive foreign income tax.

b. "Investment management services" are a substantial quantity of any of the "bad" services which are provided in the conduct of a trade or business of providing such services.

c. If an underpayment results from the application of this provision, a 40% penalty applies and the section 6664 reasonable cause penalty cannot be utilized.

6. A special exemption is provided for REITs. As a result, changes proposed in H.R. 3996 would not affect the character of income received by a REIT for purposes of the qualifying income requirement under Section 856.

7. Generally, effective November 1, 2007 (effective for purposes of applying section 7704 to years beginning after 12/31/09).

8. Legislative regulatory delegation to prevent avoidance of section 710 AND coordinate section 710 with other provisions of subchapter K.

C. H.R. 2785 and S. 1624 would cause entities deriving income as an "investment adviser" or as a person associated with such a person (as defined in the Investment Advisers Act) or from asset management services to such persons to be ineligible for the qualifying income exception to publicly traded partnership status (i.e., if publicly traded, such entities would be taxed as associations).

D. Status/History and Prediction on H.R. 2834 and H.R. 3996. Neither the Senate nor the House voted on H.R. 2834. The House passed H.R. 3996 which included the provision described above but the Senate removed the carried interest taxation portion of the legislation (among others) before passing H.R. 3996 (as amended by the Senate). The public outcry that inspired these bills (post Blackstone IPO) has cooled-off but the need for tax revenue generating offsets will be strong starting in January 2009 when the new president pushes new legislation and the need for AMT relief increases (and few will object to raising taxes on fund managers).

III. MAJOR ISSUES WITH SECTION 710 AS PROPOSED IN H.R. 2834 AND H.R. 3996

A. INTERPRETIVE ISSUES

1. Whose trade or business? When do you have a trade or business of providing the "bad" services (rather than a trade or business of investing or trading in real estate, securities or commodities or of developing real estate)?

2. What is a "substantial quantity" of services? From whose perspective is that measured? When is that measured? Whose activities are imputed to the partner for measuring quantum of services provided by the partner?

3. What if partnership has "good" and "bad" assets? What if services are provided as to both?

4. If an interest is not an "investment services partnership interest" in one year, can it become one in a later year? Does that effect prior years? If an interest is an "investment services partnership interest" in one year, can it lose that character in a future year?

5. What is covered by "supporting activities"?

6. Are assets retained by a partnership (after the recognition events resulting in such assets have been taxed to the partners) different than contributed assets or should they be? Are expenditures made outside of the partnership for the benefit of the partnership "contributed" (e.g., a general partner satisfying a partnership liability)? Should the taxable income on grant of a compensatory interest, if any, be deemed contributed (or, if not, is there to be double taxation on this income)?

7. How can you identify reasonable allocations as to purchased interests given (a) different investment return profiles of contributing partners, (b) there may be no partners that provide no services to the partnership, and (c) varying allocations over time and among investor partners (and changing investment return profiles over time)? When is reasonableness tested and over what period?

8. How are the rules to be applied to related partnerships or to tiered partnerships?

B. ISSUES WITH INTERACTION OF SECTION 710 AND OTHER CODE PROVISIONS

1. How will an "investment services partnership interest" be treated for purposes of Section 409A?

2. Will a partner need to track separate tax basis for purchased interests and "investment services partnership interests" to enable appropriate gain/income/loss recognition on distributions? If so, impact on section 752 debt allocations and adjustments made pursuant to section 734 and 743?

3. Who is a loss limited under section 710 treated under section 704(d) or 469? A loss from one "investment services partnership interest" appears to be unavailable to offset income from another "investment services partnership interest." Will a termination of a partnership under section 708(b)(1)(B) cause losses in an entity to be limited from offsetting future income of that same entity?

4. How broadly does recharacterization go? Does it change a partner's interest in partnership profits or in particular items of income (for purposes of provisions that toggle tax treatment based on such things)? Will it cause a partner to be a non-resident of a Contracting State for purposes of the newly signed U.S.-Canada tax treaty protocol?

5. Is the recharacterization to be taken into account before or after analyzing the substantiality of partnership allocations?

6. Will section 707(a)(2)(A) apply before or after or instead of section 710?

7. Can property be distributed in liquidation of an "investment services partnership interest" to achieve capital treatment, utilizing the basis rules of section 732(b)?

8. In applying section 751(b), how will the "investment services partnership interest" be treated where the partner also owns a purchased interest?

9. Do capital account book ups on the admission of new partners or a Section 708 termination affect the calculation of invested capital?

10. How does section 710 interact with the proposed regulations under section 83 applicable to partnership interests issued for services?

C. ISSUES WITH PARTNERS THAT DO NOT HOLD "INVESTMENT SERVICES PARTNERSHIP INTERESTS". Can partners utilize inside/outside basis disparities that are created? Can non-service partners utilize this provision to avoid loss limitation provisions? Will non-service partners in entities that engage in "bad" activities have ordinary income (and, if they are foreign, a U.S. trade or business or, if they tax-exempt, UBTI)?

D. SCOPE ISSUES. If this was intended to cover "hedge funds" and "venture funds", why is it so broad? Should there be exceptions for non-capital assets held by the partnership? Should there be a small business, small partnership or small partner exception?

E. COMPARISON WITH SECTION 83. A service provider is worse off under H.R. 2834/3996 than the recipient of stock under Section 83. A Section 83(b) election or vesting freezes the amount of ordinary income recognized. Qualifying dividends and gain on subsequent appreciation are generally taxed as long-term capital gain. Income with respect to an investment services partnership interest is always ordinary income.

IV. FUND MODELS – TAXATION OF GP/MANGER'S PROFITS COMPENSATION

CAVEAT: The examples below are included only to generally outline the taxation of a GP/manager's compensation to start the conversation about the overall tax picture in this

area and show why HR 2834/3996 was proposed and its possible impact. Many rules/items are not included below such as self-employment tax and the impact of UBTI on tax-exempt LPs.

A. REAL ESTATE FUND

Profits Interest = 20%
Typical Profits = Long Term Capital Gain
Investors = 100% taxable

EXAMPLE - RE Fund realizes $100M in LTCG in 2007, taxed as follows.

1. Current Law with Profits.

Partner	Allocation of Gain	Character of Income	Allocation of Compensation Deduction	Net Income Allocation	Tax on Income
GP	$20M	LTCG	None	$20M	$3M
LP – taxable	$80M	LTCG	None	$80M	$12M
Total	$100M			$100M	$15M

2. Current Law with 20% Compensation Bonus (not profits interest/partnership interest).

Partner	Allocation of Gain	Character of Income	Allocation of Compensation Deduction	Net Income Allocation /Bonus Paid	Tax on Income
GP/Mgr	$0M	OI	$0	$20M	$7M
LP – taxable	$100M	LTCG	$20M	$80M	$8M-12M (see note "a" immediately below)
Total	$100M		$20M	$100M	$15M-19M

Notes:

a. The LP's tax will be between $8M-12M depending on certain rules and factors such as if he has ordinary income to reduce with his $20M Form K-1 business loss and can use this loss against that income (which would reduce his income tax at 35% rate instead of 15% capital gain rate). Most likely, the LP's total tax will be closer to $12M.

b. In some cases a compensation deduction taken by the partnership resulting in a business loss allocated to an LP will be suspended.

c. In some cases the deduction for the manager's compensation will be required to be capitalized by the partnership and will reduce the amount of capital gain realized by the LP upon sale of the partnership's asset(s) instead of providing the LP with a deduction when the compensation is paid.

d. In theory, the No. 2 chart above should yield the same total tax result as the No. 1 chart above ($15M) because the increase in tax paid by the GP/Mgr due to the 35% rate applicable results in a decrease in tax paid by the LP from the compensation deduction flowing through as a business loss usable against income taxed at 35%. In practice, however, there are many provisions and realities which prevent the LP from being able to use the deduction at 35%.

3. Proposed Law (HR 2834/3996) with Profits Interests.

Partner	Allocation	Character of Income	Allocation of Compensation Deduction	Net Income Allocation	Tax on Income
GP	$20M	OI	None	$20M	$7M
LP – taxable	$80M	LTCG	None	$80M	$12M
Total	$100M			$100M	$19M

Note: HR 2834 and HR 3996 do not provide a partnership with a deduction in the event an income allocation to a holder of an ISPI is characterized as ordinary income.

4. Summary. Under current law, the most tax-efficient model for the "typical" real estate partnership outlined above is to use a profits interest to compensate the GP which is now standard practice. Using a non-profits interest bonus only (tied to profits) in theory (if several factual and IRC hurdles can be navigated) could end up being as tax-efficient but it will not be better. If HR 2834/3996 or something similar is passed, this appears to increase the total tax liability of the venture to the point where other structures for the venture might be worth considering. Is the goal of HR 2834/3996 to increase the total tax paid by the venture or to shift more of the tax burden to the GP since their income or more akin to compensation for services?

B. HEDGE FUND

Profits Interest = 20%
Typical Profits = Short Term Capital Gain
Investors = 50% tax-exempt, 50% taxable

EXAMPLE - Hedge Fund realizes $100M in business/trading income in 2007, taxed as follows.

1. Current Law with Profits Interest.

Partner	Allocation	Character of Income	Allocation of Compensation Deduction	Net income allocation	Tax on Income
GP	$20M	STCG	None	$20M	$7M
LP - taxable	$40M	STCG	None	$40M	$14M
LP – tax-exempt	$40M	STCG	None	$40M	$0
Total	$100M			$100M	$21M

2. Current Law with 20% Compensation Bonus (not profits interest/partnership interest).

Partner	Allocation	Character of Income	Allocation of Compensation Deduction	Net Income Allocation/ Bonus Paid	Tax on Income
GP/Mgr	$0M	OI	$0	$20M	$7M
LP – taxable	$50M	STCG	$10M	$40M	$14M
LP- tax-exempt	$50M	STCG	$10M	$40M	$0
Total	$100M		$20M	$100M	$21M

3. Proposed Law (HR 2834/3996) with Profits Interests.

Partner	Allocation	Character of Income	Allocation of Compensation Deduction	Net Income Allocation	Tax on Income
GP	$20M	OI	None	$20M	$7M
LP – taxable	$40M	STCG	None	$40M	$14M
LP – tax exempt	$40M	STCG	None	$40M	$0
Total	$100M			$100M	$21M

4. Summary. Ventures which are trading securities or otherwise acting as dealers – like many hedge funds – will likely not be impacted by HR 2834/3996 since all income is taxed at 35% anyway.

C. PRIVATE EQUITY FUND (VENTURE CAPITAL OR BUY-OUT)

Profits Interest = 20%

Typical Profits = Long Term Capital Gain
Investors = 50% tax-exempt, 50% taxable

EXAMPLE – PE Fund realizes $100M in LTCG in 2007, taxed as follows.

1. Current Law with Profits Interest.

Partner	**Allocation**	**Character of Income**	**Allocation of Compensation Deduction**	**Net income allocation**	**Tax on Income**
GP	$20M	LTCG	None	$20M	$3M
LP – taxable	$40M	LTCG	None	$40M	$6M
LP – tax-exempt	$40M	LTCG	None	$40M	$0
Total	$100M			$100M	$9M

2. Current Law with 20% Compensation Bonus (not profits interest/partnership interest).

Partner	**Allocation**	**Character of Income**	**Allocation of Compensation Deduction**	**Net Income Allocation/ Bonus paid**	**Tax on Income**
GP/Mgr	$0	OI	$0	$20M	$7M
LP – taxable	$50M	LTCG	$10M	$40M	$4M-6M (see note "a" immediately below)
LP- tax-exempt	$50M	LTCG	$10M	$40M	$0
Total	$100M		$20M	$100M	$11M-13M

a. The taxable LP's tax will be between $4M-6M depending on certain rules and factors such as if he has other ordinary income to reduce with his $10M Form K-1 business loss and can use this loss (allocated to him from the partnership so it reduces his tax at 35% rate instead of 15% capital gain rate). Most likely, his total tax will be closer to $6M.

b. In some cases a compensation deduction taken by the partnership resulting in a business loss allocated to an LP will be suspended.

c. In some cases the deduction for the manager's compensation may need to be capitalized by the partnership and will reduce the amount of capital gain realized by the LP upon sale of the partnership's asset(s) instead of providing the LP with a deduction when the compensation is paid.

3. Proposed Law (HR 2834/3996) with Profits Interests.

Partner	Allocation	Character of Income	Allocation of Compensation Deduction	Net income allocation	Tax on Income
GP/Mgr	$20M	OI	None	$20M	$7M
LP – taxable	$40M	LTCG	None	$40M	$6M
LP – tax exempt	$40M	LTCG	None	$40M	$0
Total	$100M			$80M	$13M

4. Summary. Under current law, the most tax-efficient model for the "typical" PE fund outlined above is to use a profits interest to compensate the GP which is now standard practice. If HR 2834/3996 or something similar is passed, this will increase the total tax liability of the venture to the point where alternative structures for the venture might be worth considering.

D. FAMILY BUSINESS

EXAMPLE - Mom and Dad own and operate a building-supply company formed as an LLC and grant their son a 20% profits interest when he joins the company after college. Son works for the company, expands it and increases its profitability over 10 years and sells it for a profit of $10M.

1. Current Law

Partner	Allocation of Gain	Character of Income	Allocation of Compensation Deduction	Net Income Allocation	Tax on Income
Son	$2M	LTCG	0	$2M	$300k
Parents	$8M	LTCG	0	$8M	$1.2M
Total	$10M		0	$10M	$1.5M

2. Proposed Law (HR 2834/3996) with Profits Interests.

Partner	Allocation	Character of Income	Allocation of Compensation Deduction	Net Income Allocation	Tax on Income
Son	$2M	OI	0	$2M	$700k
Parents	$8M	LTCG	0	$8M	$1.2M
Total	$10M		0	$10M	$1.9M

Note: The profits interest given to the son was likely given at least partially for estate planning purposes. HR 2834/3996 would end up taxing the son at a higher rate than the parents which is a bad estate planning result. It may have been better for the parents to have loaned or gifted money to the son to buy a portion of their capital interests in the company.

V. PLANNING IDEAS TO DEAL WITH POSSIBLE CHANGES TO TAXATION OF CARRIED INTERESTS

A. If you represent GPs or ventures with profits interests, should you be doing anything now to deal with this possible change in the taxation of carried interests? Example – Include one of the following provisions in new LP/LLC agreements that provide if H.R. 2834/3996 (or similar provision) becomes law:

1. Carry is grossed up by 30% (e.g., from 20% to 26%) to compensate for tax rate change to GP.

LPs are surely to object to this provision in that it changes the deal terms and gives more of the profits to the GP.

2. Change profits interest to straight management/employee compensation/bonus arrangement to attempt to obtain deduction for payment to GP.

Questions whether this conversion of a profits interest to an employment arrangement would be respected, whether it would be considered a taxable disposition/exchange of the profits interest and whether resulting deduction to the partnership would be helpful.

3. Allow interim valuation of partnership assets (immediately before the effective date of the law changing the taxation of carried interests) and payout of cash/note of deemed profits to the GP who will then contribute the cash/note for capital interest (convert profits interest with "accrued/unpaid profits" to capital interest).

This strategy depends on a prospective effective date of the passed carried interest taxation provision so the valuation and payout can be done prior to the effective date. HR 2834 and HR 3996 both generally have retroactive effective dates.

B. Tax Distribution Provisions in LP/LLC Agreements. Will H.R. 2834/3996 impact LLC/LP agreements with tax distribution provisions? In some cases it may only impact the timing of distributions if tax distributions are required to be made to the GP to cover allocations made at 35% tax rate instead of 15% tax rate. In some cases, H.R. 2834/3996 could cause a tax distribution provision to distribute more to the GP over the life of a venture especially if only the first tiers of distribution waterfall are satisfied. In any event, tax distribution provisions in new LLC/LP agreements should be reviewed with H.R. 2834/3996 in mind.

C. If HR 2834/3996 (or similar provision) is passed, should you change how to structure these deals in the future?

1. Change profits interest to straight employment compensation/bonus tied to profits of venture. Need to structure to be a guaranteed payment rather than a partnership distribution.

Attempt to obtain deduction for payment made to GP taxed at 35% rate for partnership to use and allocate to partners to use against income taxed at higher rate. There are serious questions, however, whether this deduction would be available and whether it could be used against income taxed at higher rate.

2. S corporation alternative

The manager could be granted stock (equivalent to a capital interest in a partnership) in an S corp, pay tax at ordinary income rates on the value of the stock and receive capital gain on any later appreciation in the stock (profits realized). However, most managers will not want to pay tax up front on the stock grant without any liquidity and holding appreciating property in an S corp is less flexible than a partnership.

> Example – Manager finds raw land he intends to entitle. Forms S corp and X and Y each put in $100,000 to the S corp for 50% of stock which is used to buy the land. The S corp issues 20% of stock to Manager – value of stock is $40,000 taxable as ordinary income to Manager and deductible to the S corp. Land is later sold and $600,000 distributed - $120,000 to Manager. Profits paid to the Manager should be taxed as capital gain.

3. GP borrows money from bank to buy capital interest instead of using carry.

In lieu of a profits interest, a GP could borrow money from a bank and purchase a capital interest in the partnership to avoid ordinary income rates on its carry. H.R. 2834/3996 contain certain rules governing the use of loans to buy capital interests. See, e.g., Proposed section 710(c)(2)(D)(i).

D. Penalty provisions applicable to creative solutions**.** H.R. 3996 provides that Treasury propose anti-abuse regulations to the legislation and that the penalty for underpayments attributable to the application of such anti-abuse regulations is 40% (and the reasonable cause exception to the penalty is not available). See Section 611(c)(2) of H.R. 3996.

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Pursuant to requirements relating to practice before the Internal Revenue Service, any tax advice in this communication (including any attachments) is not intended to be used, and cannot be used, for the purpose of (i) avoiding penalties imposed under the United States Internal Revenue Code, or (ii) promoting, marketing or recommending to another person any tax related matter.

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