WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

PREPARING FOR THE POSSIBLE ENACTMENT OF CARRIED INTEREST LEGISLATION

With the election settled, many clients are again asking about the President's controversial proposal to change the taxation of "carried interest" and what, if anything, they can do to mitigate its potential effects. We cannot predict whether or when this proposal might be enacted – or what its effective date might be – but in this memorandum we have recapped what clients should consider in anticipation of that possibility.

Summary of Where the Proposal Now Stands

"Carried interest" refers to an interest in partnership profits granted to a partner in exchange for services. In the case of private equity and hedge funds, it is the percentage of a fund's profits that the fund pays for investment advice.

Under current law, the tax character of a partnership's income and gain flows through to its partners, including in respect of carried interest. A service partner's share of the partnership's long-term capital gains, if any, is thus taxed as though directly recognized as investment income instead of as compensation for services. In addition, a partner's gain from the sale of a partnership interest, including carried interest, is generally taxed as a capital gain.

In his last several budgets, the President has proposed changing this treatment. Under this proposal, generally all or a portion of a partner's income in respect of a carried interest would be taxed as services income, if the partner provides investment-related services in respect of investment-type assets. The proposal would specifically subject the income to regular graduated tax rates applicable to ordinary income and self-employment taxation (in the case of individual service partners). Though the administration's most recent budget is not detailed, during the first half of 2012 virtually identical bills for implementing the proposal were introduced in the House and the Senate (H.R. 4016, H.R. 5727, and S. 2252).

Those bills leave largely unchanged the basic tenets of a measure approved by the House in 2010 (H.R. 4213), which we described in a Client Memorandum dated May 25, 2010 ("Taxation of Carried Interest of Fund Managers at Ordinary Income Tax Rates under Proposed American Jobs and Tax Closing Loopholes Act of 2010"). For example, like the 2010 bill, the 2012 bills would generally cover carried interest received in connection with the provision of investment-related services in respect of securities, real estate, partnership interests, commodities or derivatives on the foregoing, rejecting calls from the real estate and venture capital industries to exclude their funds from the change.

However, the 2012 bills include a number of other small or technical changes and differ significantly from the 2010 version in four important respects:

- *No Recharacterization Cap*. The 2010 bill would have recharacterized "net income" from carried interest (taking into account all items consisting of such net income) as services income and would have capped the amount of recharacterization to 75% of net income for years after 2012 (and 50% before then). The 2012 bills would recharacterize all "net capital gain," defined as net long-term capital gain in excess of net short-term capital loss, from carried interest and would not cap the amount recharacterized, but would contain anti-abuse provisions to prevent stuffing the partnership with loss assets that would otherwise limit recharacterization.

- *No Recharacterization of Enterprise Value.* The 2010 bill would have had the effect of recharacterizing gain attributable to an advisor's "enterprise value" or "goodwill" as well as gain attributable to carried interest from underlying portfolio investments. The drafters of the 2012 bills intend to shield from recharacterization gain attributable to enterprise value or goodwill. They do that by narrowing the types of partnership interests subject to recharacterization and clarifying how the recharacterization applies to tiered partnerships on a look-through basis, though as the 2012 bills are currently drafted, the scope of this relief could be more limited than was intended.

- *Limited Preservation of Nonrecognition Rules.* The 2010 bill would have required gain recognition and recharacterization for many types of transactions involving carried interest, notwithstanding that those transactions otherwise would not trigger gain under the normal nonrecognition rules. The 2012 bills would allow many of those types of transfers to be made without gain recognition, provided that the transferee elects to be subject to the recharacterization rules with respect to the transferred asset.

- *No Recharacterization of Business Joint Ventures.* The 2010 bill would have potentially applied to interests in many business joint ventures and other partnerships that are not traditionally considered investment partnerships, by reason of their holding investment assets. The 2012 bills would attempt to avoid that result by narrowing the definition of investment partnership to generally exclude partnerships with a partner that holds its interest as part of trade or business, as opposed to merely for the production of income.

<u>Possible Mitigation Strategies</u>

Preparing for the possible enactment of the carried interest proposal is difficult, especially because Congressional staffs continue to tailor it to respond to possible avoidance strategies and protect non-carry income from recharacterization. For this reason, mitigation strategies will also likely continue to evolve, but the following summarizes the ones commonly discussed.

Extracting or Accelerating Existing Carry Gain

To date, protecting existing carry from the legislation's possible enactment has been limited to one of two strategies. The first removes built-in gain attributable to accrued but unrealized carried interest from the investment partnership so that the gain, when recognized, is not subject to the legislation. This is usually accomplished through in-kind distributions of securities with equal value. The second strategy accelerates the built-in gain attributable to accrued but unrealized carry into a period prior to the legislation's effective date.

For most hedge funds, which crystallize carried interest annually, any previously unrecognized gain attributable to the carried interest likely can be protected from the legislation (while remaining unrecognized) by having the fund pay out the carry in the form of securities. Many hedge fund sponsors have done this. So far, none of the versions of the proposal would taint the gain ultimately realized on those distributed securities. In fact, some of the technical changes in the 2012 bills allow this strategy to be implemented more easily.

Applying this strategy to private equity funds is much more cumbersome and may be impossible, depending on the fund documents, because paying carry before realization is usually inconsistent with the sponsor's commercial agreement with investors. Nevertheless, some private equity fund sponsors have put in place structures that attempt to extract their right to accrued but unrealized carry from the fund in a manner that protects it from the legislation. To do this, they usually have obtained investor consent and have used structures that largely avoid any material adverse effect to investors and have accepted that commercially insulating investors may undermine the efficacy of the structure.

Some private equity sponsors with significant accrued and unrealized gain on their carried interest have chosen to simply accelerate that gain, usually by transferring the carried interest or the vehicle containing the carried interest to an affiliate in a manner that is taxable. Depending on how the transfer is implemented and the terms of the relevant fund documents, this strategy may not require investor consent, though most sponsors provide investor notice of the transfer in any event. Structuring the transfer to trigger gain from carry in only particular (but not all) portfolio investments is sometimes possible, depending on the fund structure, but usually does require investor consent under the relevant fund documents. In any structure requiring consent, some investors may resist providing it if they perceive the transfer as at all compromising their interest. Each fund will likely require a carefully customized approach.

Protecting Management Fee Waivers

Fund interests issued in respect of management fee waivers are also a form of carried interest and would be covered by any of the versions of the proposed legislation. Very generally, this form of carried interest represents a profits interest equal in value to the amount that would have been received if the waived management fee had been actually invested in the fund (subject to there being profits of that amount).

The strategies for protecting this type of carried interest are similar to those for regular carried interest. However, in the case of carry from fee waivers, it is likely easier to implement these strategies while preserving the commercial agreement with investors. For example, if after the waiver there have been sufficient profits to equal the amount of value that the sponsor would be entitled to had the sponsor invested the waived fee, then distributing to the advisor securities equal to such value would potentially shield the gain from recharacterization under the legislation and should not affect investors. However, doing so may require obtaining investor consent, depending on the fund documents. As with distributions in respect of regular carry, these distributions must be carefully structured to minimize the risk that they are not respected (or that the vehicle holding the carry is itself subject to the legislation).

Other Considerations

The 2012 bills contain provisions intended to protect from recharacterization gains from the fund sponsor's actual investment in the investment partnership ("qualified capital interests") and gains attributable to the sponsor's enterprise value or goodwill if, for example, all or a portion of the sponsor's business is sold. However, because these protections are narrowly drafted, it would be worthwhile for sponsors to review their fund documents to ensure that their fund investments and goodwill will qualify for these protections.

For example, a sponsor's contributions financed with loans from the fund or its investors generally cannot result in qualified capital interest. However, because repaying these loans prior to the proposal's enactment would clear that taint, sponsors should consider refinancing them now.

In addition, how the legislation would apply to investors in fund sponsors is not entirely clear. The legislation directs regulations to be issued to protect many types of investors from many of the effects of recharacterization, but the intended scope of this relief is unclear. If the investor's participation in the sponsor's profits depends on the investor's maintaining a large investment in the sponsor's funds, this regulatory uncertainty can often be avoided with minimal disruption to the parties' commercial agreement by structuring their fund investments to provide returns that simulate an investment in the sponsor. Sponsors with third-party investors should consider the appropriateness of such restructuring.

Finally, the 2012 bills continue to generally exclude from their scope equity-based compensation in domestic C corporations, though they authorize regulations to include such compensation. Many have publicly discussed how fund economics can be largely replicated outside of a partnership through the use of stock-based compensation. Under these structures, the fund sponsor would not hold a partnership interest in the fund but would instead take its performance compensation directly from the underlying portfolio investments in the form of stock that entitles the sponsor to a percentage of future income and appreciation. Providing investors with the equivalent of a clawback that limits the sponsor's compensation to a percentage of profits that nets performance across all portfolio investments raises additional issues under the 2012 bills. Depending on the final form of the legislation changes, these structures may become more attractive or be specifically prohibited.

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If you have any questions regarding this memorandum, please contact James R. Brown (212-728-8287, jbrown@willkie.com), Hillel N. Jacobson (212-728-8655, hjacobson@willkie.com), Richard L. Reinhold (212-728-8292, rreinhold@willkie.com), Joseph A. Riley (212-728-8715, jriley@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

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