

STAY AHEAD OF THE CURVE

July 22, 2010 – 6:30 PM

A Hedge Fund General Counsel Dinner at: *Innis Arden Golf Club, Old Greenwich, CT*

A Long Slow Death for Carried Interest or Can Tax Legislation Really Modify the Behavior of Hedge Funds?

Speaker: Mark Lange, Partner (Atlanta) McKenna Long & Aldridge LLP



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CARRIED INTERESTS

- **TRADITIONALLY DEFINED AS A PROFITS INTEREST RECEIVED IN EXCHANGE FOR MANAGEMENT SERVICES**
- **INCOME RECOGNITION DEFERRED UNTIL EARNINGS ACTUALLY REALIZED, FREQUENTLY TAXED AT CAPITAL GAIN RATES**

PROPOSED CHANGE: HR 4213

HR 4213, PASSED BY THE HOUSE ON MAY 28, CONTAINS A PROPOSAL TO TAX THE INCOME RECEIVED FROM A CARRIED INTEREST AS ORDINARY INCOME

INVESTMENT SERVICES PARTNERSHIP INTEREST

- **PROVISION APPLIES TO INCOME RECEIVED FROM AN INVESTMENT SERVICES PARTNERSHIP INTEREST (ISPI)**
- **ISPI IS PARTNERSHIP INTEREST HELD BY PERSON REASONABLY EXPECTED TO PROVIDE SUBSTANTIAL QUANTITY OF SERVICES WITH RESPECT TO ASSETS HELD BY THE PARTNERSHIP**

MEANING OF SERVICES

- ADVISING ON ADVISABILITY OF INVESTING IN, PURCHASING OR SELLING ASSETS
- MANAGING, ACQUIRING OR DISPOSING OF ANY SPECIFIED ASSET
- ARRANGING FINANCING FOR THE ACQUISITION OF ASSETS
- ANY ACTIVITY IN SUPPORT OF THE ABOVE

SPECIFIED ASSETS

- SECURITIES
- REAL ESTATE HELD FOR RENTAL OR INVESTMENT
- INTERESTS IN PARTNERSHIPS, COMMODITIES OR OPTIONS
- DERIVATIVES WITH RESPECT TO ALL OF THE ABOVE

QUALIFIED CAPITAL INTEREST EXCEPTION

- RETURNS ON INVESTED CAPITAL PROVIDED
 - INVESTMENT IS MADE ON SAME TERMS AS PARTNERS NOT PROVIDING SERVICES
 - SPECIFICALLY, ALLOCATIONS MUST BE THE SAME AS ALLOCATIONS TO PARTNERS WHO ARE UNRELATED AND DO NOT PROVIDE SERVICES

LOSSES, DISPOSITION AND DISTRIBUTIONS RELATED TO ISPI

- LOSSES: ORDINARY INCOME TAX TREATMENT, BUT LIMITED TO EXCESS OF PRIOR INCOME OVER PRIOR LOSSES
- DISPOSITIONS OF THE ISPI ITSELF TAXED AS ORDINARY INCOME
- DISTRIBUTIONS OF PROPERTY – BUILT IN GAIN TAXED AT ORDINARY INCOME, PLUS ANY GAIN RESULTING FROM VALUE OF PROPERTY THAT EXCEEDS BASIS

EFFECTIVE DATE

- EFFECTIVE TO INCOME RECEIVED FROM AN ISPI FOR TAXABLE YEARS ENDING AFTER 12/31/2010
- IF THE PARTNERSHIP TAXABLE YEAR INCLUDES 12/31/2010, THEN APPLICABLE TO THE LESSOR OF NET INCOME FOR ENTIRE YEAR OR NET INCOME ONLY ATTRIBUTABLE TO PORTION OF YEAR AFTER EFFECTIVE DATE

APPLICATION OF NEW SECTION 710 WILL BE EXTRAORDINARILY COMPLEX.

SECTION 710 WOULD RESULT IN ONLY PARTIAL RECHARACTERIZATION OF THE SERVICE PARTNERS DISTRIBUTIVE SHARE AS ORDINARY INCOME.

THE BALANCE CANNOT BE EASILY RECONCILED WITH SUBCHAPTER K PROVISIONS.

BECAUSE THERE IS NO EXCLUSION FOR ACCRUED CARRIED INTEREST BASED ON UNTAXED APPRECIATION EARNED BEFORE THE EFFECTIVE DATE. MANY VIEW THE TAX INCREASE AS RETROACTIVE.

UNDER SECTION 710, A SERVICE PARTNER'S SHARE OF PROFITS WOULD GENERALLY BE RECHARACTERIZED AS ORDINARY EXCEPT TO THE EXTENT THAT THE ALLOCATION REFLECTS A REASONABLE RETURN ON A QUALIFIED CAPITAL INTEREST.

QUALIFIED CAPITAL CONSISTS OF CONTRIBUTED CAPITAL INCREASED BY EARNED CAPITAL (INCOME IN EXCESS OF LOSSES) AND DECREASED BY DISTRIBUTIONS AND LOSSES IN EXCESS OF INCOME.

QUALIFIED CAPITAL IS THE BASELINE FOR DETERMINING THE PORTION OF THE SERVICE PARTNER'S RETURN THAT IS TREATED AS INVESTMENT RETURN (RATHER THAN COMPENSATION).

**WHAT CAN BE DONE TO
AMELIORATE THE INCREASED
ORDINARY INCOME EXPOSURE
PRIOR TO THE EFFECTIVE DATE
(WHICH MAY WELL BE JANUARY 1, 2011)?**

1. EXISTING CARRIED INTERESTS

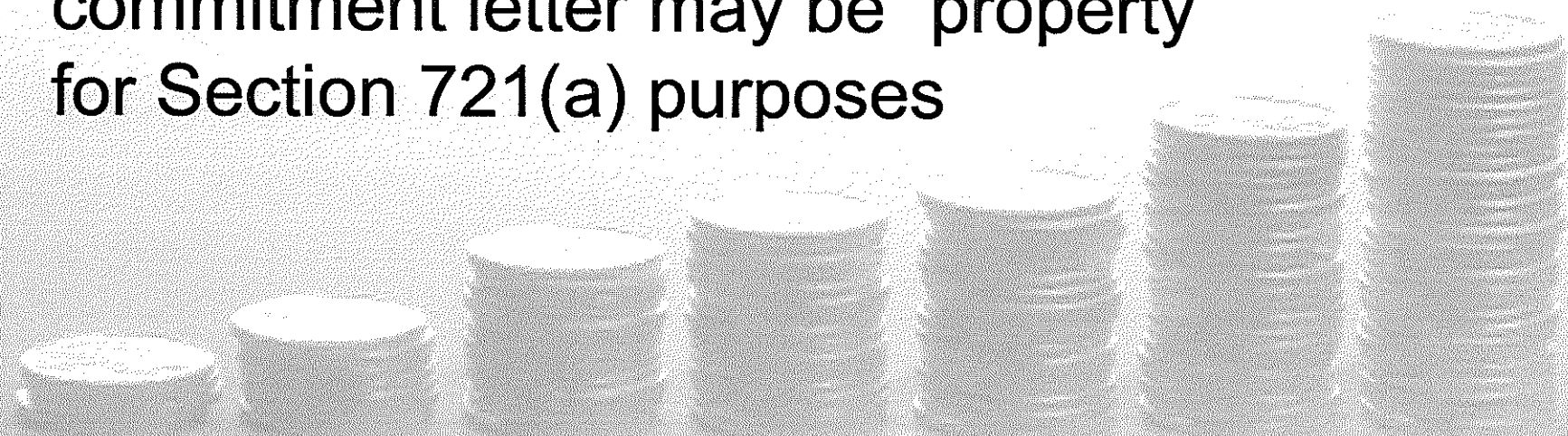
- **VALUE THEM NOW IN CONTEXT OF EXISTING FUNDS**

- **DISTRIBUTE SECURITIES OUT OF PARTNERSHIP AS PAYOUT ON CARRIED INTEREST/ REDEMPTION OR OTHERWISE NO 2010 GAIN RECOGNITION UPON RECEIPT OF IN KIND DISTRIBUTION GENERALLY.**

- **RESTRUCTURE PARTNERSHIP AND EXCHANGE CARRIED INTEREST PLUS NEW “PROPERTY” CAPITAL CONTRIBUTION FOR NEW CAPITAL INTEREST (BASED ON QUALIFIED CAPITAL CONCEPTS) IN TAX FREE SECTION 721 TRANSACTION (THE CARRIED INTEREST DISAPPEARS IN THIS SCENARIO).**

- **WHERE DO YOU GET THE “NEW” PROPERTY TO PUT INTO THE PARTNERSHIP RECAPITALIZATION?**
- **CONSIDER VALUE ASSOCIATE WITH VARIOUS CONTRACTUAL RIGHTS OWNER OF CARRIED INTEREST HAS OR HAS CREATED SINCE FORMATION**

U.S. v. Stafford (nonbinding LOI/Loan commitment letter may be “property” for Section 721(a) purposes



- IF 15% RATE ON “QUALIFIED DIVIDENDS” TO SHAREHOLDERS BY DOMESTIC “REGULAR” CORPORATION UNTIL DECEMBER 31, 2010 (PRESIDENT BUSH’S 2005 TAX CUTS) WERE TO BE EXTENDED, HOLDING CARRIED INTERESTS IN CORPORATIONS COULD PERMIT 15% DIVIDEND BLEED OUT.

- USE OF DERIVATIVES ON THE CARRIED INTERESTS
- BARNES/NOBLE STRUCTURE -- POSSIBLE USE GOING FORWARD
- RENEGOTIATIONS OF VARIOUS TERMS