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Private Equity Newsletter

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Serious Flaws in Pending Carried Interest Tax Legislation

PENpoints

Proposed Internal Revenue Code §710, which would alter long-standing income tax rules under which the character of a partnership (or LLC) profit or loss flows through to its partners, has a number of serious flaws that create substantial uncertainties about §710's scope, including its potential application to income that should not be covered.

Pending legislative proposals in Congress would enact new Internal Revenue Code §710, which would alter long-standing income tax rules under which a partnership (or LLC) profit or loss flows through to its partners (or members), whether service providers or investors, with the same tax character as in the partnership's hands. Kirkland tax partners Jack Levin, Don Rocap and Bill Welke recently published a special report (the "Special Report") analyzing proposed Code §710 in the November 1, 2010 edition of Tax Analysts' Tax Notes magazine (click here to read the full article).

In contrast to the long-standing character-flow-through regime, proposed Code §710 would tax as ordinary compensation income a portion (between 50% and 75% depending on whether the House's approach or the Senate's approach is adopted) of capital gain (or dividend income) flowing through to a service partner with respect to his carried interest from an investment or real estate partnership. (For previous KirklandPENs discussing carried interest legislative proposals, see our KirklandPENs from June 17, June 9, June 1 and May 21.)

As detailed in the Special Report, proposed §710 has a number of serious flaws, all of which stem from a common source: §710 is unduly complex, with 30 pages of rules, sub-rules, definitions, and broad grants of regulatory power, which create substantial uncertainties about §710's scope, including its potential application to income that should not be covered. The authors believe that these flaws and the potential for other unintended consequences provide a powerful argument against enacting §710.

The first three flaws stem from the fact that, although §710 is aimed at income from carried interests, it sweeps far more broadly because it taints all interests held by a service partner or related person with a carve-out for a narrowly-defined "qualified capital interest." This approach produces inappropriate results in several common fact patterns.

Flaw #1 – §710 may apply to a capital interest purchased with debt. §710 taints income allocated to a service partner's capital interest if the capital is acquired by the service partner using a loan from (or guaranteed by) another partner (or a person related to another partner). This treatment may make sense for a nonrecourse, low-or-no interest loan to a service partner from an unrelated non-service partner, as such a loan could be structured to mirror the economic effect of a carried interest. However, this treatment does not make sense where the loan is from (or guaranteed by) a fellow service partner or is full recourse with adequate interest or is from a family member. In these cases, the economics of the loan arrangement simply do not create a disguised carried interest.

Flaw #2 – §710 may apply to a family partnership where there is no carried interest. Although §710 is aimed at a carried interest, it may taint income earned by a family investment partnership with no carried interests, because all partners are related to each other and hence no unrelated capital partner receives capital interest allocations that are similar and "substantial" as required by §710 in order to fit within the limited and highly technical qualified-capital-interest exception. §710 would allow IRS to offer regulatory relief, but such relief is likely to be a long time coming and uncertain in ultimate scope. In addition, while the Senate (but not the House) bill contains a specific family partnership relief clause (that can be overridden by IRS), such relief is conditioned on the family partnership not investing any amount in any other partnership (e.g., an unrelated hedge fund or private equity fund) that allocates a carried interest to anyone (even to a person

INSIDE KIRKLAND**PEN**

wholly unrelated to the family partnership and its partners).

Flaw #3 – §710 may apply to a pure investor. Although §710 is aimed at a service provider's carried interest, it nonetheless sweeps in a pure investor in the following circumstances: where (1) an upper-tier management partnership holds both a carried interest and a capital interest in a lower-tier fund partnership (engaged in investment or real estate activity) and (2) the upper-tier partnership's equity owners include one or more service providers and one or more pure investors. In such case, the portion of the upper-tier partnership's carried interest allocable to the pure investors is §710-tainted, even though they are not rendering services. This situation arises, for example, where a large (anchor) pure investor invests in a fund through the upper-tier management partnership and is granted a portion of the carried interest. §710 creates this unexpected result for the pure investor's carried interest because the upper-tier partnership is rendering services to the lower-tier fund and hence the upper-tier entity's entire carried interest (even the portion allocable to the pure investors) is tainted.

Flaw #4 – §710 may apply to an interest in an active operating partnership. Although §710 is aimed at partners who manage investment and real estate funds, as shown in the following 3 examples it sweeps far more broadly and may taint an interest in a partnership that indirectly (in example (1) below) or directly (in examples (2) and (3) below) operates a non-investment, non-real-estate business:

Example 1: A partnership holding company that engages indirectly in an active (i.e., a non-investment, non-real estate) business through a subsidiary operating partnership or corporation may be §710 tainted because the holding partnership owns an equity interest in the operating partnership or the operating corporation (labeled a "specified asset" by §710 which thus may invoke §710).

Example 2: An operating partnership directly (itself) engaged in an active (non-investment, non-real estate) business may be §710 tainted if it also owns a "specified asset" in connection with its business (e.g., interest rate or currency swaps employed to manage interest rates on borrowed capital or foreign currency fluctuations on foreign sales, or vacant land next to its factory, or an office or factory building with excess space rented out, all of which are labeled "specified assets" by §710 and thus may invoke §710).

Example 3: An operating partnership directly (itself) engaged in an active (non-investment, non-real estate) business may be §710 tainted if it also owns a portfolio of investments (e.g., stocks and bonds which are "specified assets" and thus may invoke §710), perhaps purchased with accumulated business profits.

Flaw #5 – §710's enterprise value tax is overly broad. By applying §710 to all of the gain from disposition of a service partner's carried interest (broadly defined as described above) in a business holding specified assets including gain attributable to an investment or real estate management business's goodwill (the so-called "enterprise value tax"), §710 treats such disposition gain far more harshly than warranted by the reasons for enacting §710 advanced by the bill's supporters and treats an entrepreneur who builds an investment or real estate management business (and perhaps an operating business holding specified assets) in partnership form far more harshly than an entrepreneur who builds a non-investment, non-real estate business (1) in partnership form or (2) in corporate form.

If Congress chooses to enact §710 as a policy matter, the authors argue that any §710 taint on the sale of a carried interest should be limited to the gain that would be allocated to the carried interest if the underlying investment or real estate fund sold its investments or real estate at their fair market value. This more limited approach would prevent a service partner from avoiding §710 by selling his carried interest prior to a fund-level asset sale, but would avoid unnecessarily tainting gain attributable to an investment or real estate management business's goodwill and other future expectancies which are traditionally taxed as capital gain on sale for all businesses.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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Two Additional Regulatory Changes Relating to Private Fund Managers

PENpoints

As placement agents seek to understand how new rules will apply to them, private fund sponsors should consider how their engagement letters with placement agents allocate the risks arising out of this new regulatory environment.

California Regulation of Placement Agents as Lobbyists. A new California law, effective on January 1, 2011, will require "placement agents" and certain employees and agents of a private fund sponsor who solicit California state public retirement plans[1] (or a feeder vehicle in which a California plan invests[2]) on behalf of an investment manager to register as lobbyists and abide by related regulations.

An investment manager's employee or agent involved in soliciting or otherwise acting as an intermediary in connection with a California state retirement plan's potential investment with the manager would be deemed a placement agent required to register as a California lobbyist (and hence subject to the related regulations), unless that person also spends one-third or more of his or her time during a calendar year "managing the securities or assets"[3] of the manager. This is a concern for internal marketing and investor relations professionals, but may also be relevant for other employees of a fund sponsor involved in the offer or sale of the securities or services of the sponsor who do not spend one-third or more of their time on asset management activities.[4]

A placement agent deemed to be a lobbyist under the new law must also comply with California's lobbyist rules,[5] including a ban on receiving compensation contingent on the California state retirement system's decision to enter into a contract to invest the system's assets (as well as gift bans, limits on campaign contributions, ongoing ethics training and periodic public disclosures, including detailed reporting on fees paid to such lobbyists). The ban on contingent compensation should not impact a fund manager's ability to receive carried interest or management fees, as the "placement agent" definition extends only to third-party placement agents and to individual personnel not exempt from the law, not to the fund manager itself.

A knowing or willful violation of the California lobbying rules is a misdemeanor subject to criminal penalties. In addition, late filing of required disclosure statements may result in a fine.

As a result of the new law, private fund managers should (1) determine which, if any, of their employees could be deemed a California "placement agent" required to register as a lobbyist and (2) review internal compliance policies and compensation arrangements for those employees to determine whether existing compensation arrangements are permissible, and what additional actions, if any, might be needed to comply with the lobbying rules.

Managers should also bear in mind this California law when entering into an engagement agreement with a placement agent, particularly provisions relating to whether and how to solicit California state retirement plans (and related compensation terms), representations as to compliance with applicable law and disclosure matters.

Dodd-Frank Act May Regulate Placement Agents Soliciting Local Public Pension Plans as "Municipal Advisors." In an effort to reform regulation of the municipal securities industry, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") requires newly defined "municipal advisors" to register with the SEC and subjects them (as of October 1, 2010) to substantive regulation under the Securities Exchange Act of 1934 (the "Exchange Act"), as well as rules to be promulgated by the Municipal Securities Rulemaking Board ("MSRB"). The definition of municipal advisor in the Dodd-Frank Act is broad enough to subject placement agents soliciting investments by local public pension plans on behalf of private fund managers to these new regulations.

In addition to registration, the Dodd-Frank Act makes municipal advisors subject to the anti-fraud provisions of the Exchange Act, and imposes fiduciary duties on municipal advisors in favor of the municipal entities with whom they work. The Dodd-Frank Act does not specify what fiduciary duties are owed, leaving it up to the MSRB to develop the applicable regulations. The MSRB has stated that it intends to adopt a "comprehensive set of rules" for municipal advisors designed to prohibit fraudulent and manipulative practices, set forth municipal advisors' fiduciary obligations to their municipal clients and restrict real and perceived conflicts of interest.

As placement agents seek to understand how these new obligations will apply to them, private fund sponsors should consider how their engagement letters with placement agents allocate the risks arising out of this new regulatory environment and whether the placement agent's plans for addressing these new requirements could affect the sponsor's rights and obligations.

1 The California state public retirement systems include (1) the California Public Employees' Retirement System ("CalPERS"), which administers the Judges' Retirement Fund, the Judges' Retirement Fund II, the Legislators' Retirement Fund, the State Peace Officers' and Firefighters' Defined Contribution Plan Fund, the Public Agency Deferred Compensation Program and the public employee Supplemental Contributions Program Fund, and (2) the California State Teachers' Retirement System ("CalSTRS").

2 Solicitation of a California state retirement plan includes seeking an investment from a vehicle that is majority-owned by a California state public retirement system if such vehicle was organized to invest with, or retain the investment management services of, one or more external managers—capturing, for example, solicitation of a dedicated "feeder vehicle" established by a gatekeeper primarily for a California retirement plan.

3 Because the bill does not contain guidance as to what activities constitute "managing ... securities or assets," it is unclear how broadly to interpret the functions that may fall within this exception.

4 A second exception requires an investment manager to be chosen by CalPERS or CalSTRS in a competitive bidding process. Because neither plan typically chooses to invest in a private fund through a competitive bidding process, this exception is unlikely to be of use to private fund managers.

5 The law also requires a placement agent soliciting a local (i.e., not state-wide) public retirement system to file any reports that other lobbyists of such local agency are required to file.

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PENnotes

The University of Chicago Booth School of Business' Fourth Annual Real Estate Conference
Chicago, Illinois
November 11, 2010

The University of Chicago's Booth School of Business Fourth Annual Real Estate Conference will take place at the Gleacher Center in Chicago, Illinois on November 11, 2010. The keynote speaker will be Neil G. Bluhm, managing principal of Walton Street Capital. Kirkland partner Nathaniel M. Marrs will be a panelist. For more information, or to register, please visit: www.chicagoboothrealestateconference.eventbrite.com.

The Yale School of Management's 10th Annual Private Equity Conference
Stamford, Connecticut
November 12, 2010

The Yale School of Management Private Equity Conference 2010, "Building on a Decade of Insight," will be held at the Hilton Stamford Hotel on November 12, 2010. The conference will bring together panelists and industry professionals to discuss topics including limited partner perspectives—when incentives diverge; operating in a dynamic regulatory environment; opportunities in emerging markets and investing in the private equity secondaries market. Kirkland partner Stephen Fraidin will be a keynote speaker at this event. For more information, or to register, please visit: www.pe.som.yale.edu.

The Practising Law Institute's Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2010
Chicago, Illinois
November 16 - 18, 2010

This three-day PLI program will focus on the tax issues presented by the entire spectrum of modern major corporate transactions, from single-buyer acquisitions of a division or subsidiary to multi-party joint ventures, cross-border mergers, and complex acquisitions of public companies with domestic and foreign operations, including spin-offs and other dispositions of unwanted operations. Kirkland partner Jack S. Levin, P.C., will speak on "Structuring Leveraged Buyouts," partner Jeffrey T. Sheffield, P.C., will speak on "Current Issues in Divisive Strategies—Spin-Offs and Synthetic Spin-Offs" and partner Gregory W. Gallagher will be speaking on "Tax Strategies for Financially Troubled Businesses and Other Loss Companies." For more information, or to register, please visit: www.pli.edu.

Infrastructure Investor and PEI Media's Infrastructure Investor: Chicago Conference
Chicago, Illinois
November 18 - 19, 2010

The Infrastructure Investor conference, sponsored by Kirkland & Ellis, will focus on U.S. infrastructure needs, developments and investment opportunities. Kirkland partner Sean Patrick Maloney will moderate a panel titled "The Next Generation of Infrastructure Transactions: Lessons learned from the Evolution of Parking Deals" and Kirkland partner Mitchell F. Hertz, P.C., will moderate a panel on "Private to Private Transactions." For more information, please visit: www.peimedia.com.

The IBA International Private Equity Transactions Symposium 2010: The Global Private Equity Market
London, England
November 30, 2010

At this IBA conference, panelists will discuss trends and macro issues in the global private equity market, including the state of European, U.S., Asian and Brazilian markets. There will also be a general counsels' forum. Kirkland partner Kirk A. Radke is a co-chair of this conference and partner David Patrick Eich will participate in a panel discussion on the Asian market. For more information, or to register, please visit: www.int-bar.org/conferences/conf353/.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Law Firm of the Year" in *Buyouts* magazine's "2010 Deal of the Year Yearbook," and was also honored with the 2010 "Award for Excellence" in Investment Funds by Chambers & Partners at its annual Chambers USA Awards. Kirkland was ranked in the first tier among law firms for both Private Equity Buyouts and Private Equity Funds by *The Legal 500 U.S. 2010*. Additionally, *Pitchbook* named Kirkland as one of the most active law firms representing private equity firms in its 2009 "Private Equity Breakdown."

The Lawyer magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008, 2009 and 2010, noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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