U.S. TAXATION OF CARRIED INTEREST

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INTRODUCTION

The taxation of so-called carried interest in the U.S. has received much attention over the last few years, particularly from the Obama Administration, which seeks to make their tax treatment harsher. This past month, Paul Ryan (R.-W.I.), Chairman of the Ways and Means Committee of the House of Representatives, indicated that he would not be discussing the issue of carried interest reform with his counterparts in the Democratic party. This makes it unlikely that the U.S. will overhaul the tax treatment of carried interest in 2016 or 2017. However, the I.R.S. has issued proposed regulations designed to curb carried interest in some situations.

TAX TREATMENT OF CARRIED INTEREST

"Carried interest" is the term of art used to describe a profts interest in an investment fund that is granted to an investment manager or sponsor for the work they perform in managing or selling the fund. The investment fund is generally created as a limited partnership or a limited liability company ("L.L.C.") that is treated as a partnership for U.S. tax purposes.

The equity in the investment fund is contributed by third-party investors ("Investors") who receive a share of the fund's profits. The manager ("Manager") generally contributes little or no equity and is only granted a profits interest. Generally, 100% of the cash flow from the fund is distributed to the Investors until they recieve a return of their invested capital along with a preferred return on that amount (such as 6% or 8%). Once the Investors recoup their capital and preferred return, the distribution of further profits is generally shared – 80% to the Investors and 20% to the Manager for its carried interest in the typical case.

A person who provides services, such as a Manager, is taxable on any payment they receive for the work they do, whether paid in cash or property. If a Manager is given a car for services rendered, then the Manager has to report the fair market value ("F.M.V.") of the car as taxable compensation income. However, under current U.S. tax rules, the I.R.S. generally treats the F.M.V. of a carried interest as zero if certain conditions are met, so the Manager pays no tax when it receives the carried interest – one of the key benefits of this ownership structure.

Another key benefit of a carried interest is that it is an ownership interest in a partnership, which is a pass-through entity for U.S. tax purposes. Future allocations of taxable income or gain from the investment fund to the Manager therefore retain their character in the hands of the Manager. Thus, if the partnership's income is comprised of a long-term capital gains from the sale of stocks or securities, the

Manager will have the advantage of paying the long-term capital gains rate (20%) when allocated that income.

An additional benefit is one of tax deferral, since capital gains are not typically taxed until a realized event. This allows the taxpayer to control the timing of when he or she is taxed.

The tax treatment of a carried interest has caused a debate within the upper echeleons of Washington. The Obama Administration seeks to amend the rules applicable to carried interest so all income allocated to the Manager is taxed as ordinary income (at a maximum rate of 39.6%). According to the administration, after the initial contribution, fund managers provide a service no different from the labor that other workers provide to their employers. Furthermore, the Obama Administration believes that taxing carried interest as ordinary income will generate $17.7 billion in additional revenue for the U.S. treasury. However, many in Congress do not share this belief, meaning that the legislation will likely be kept on hold until after the next presidential election or later.

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On July 22, 2015, the I.R.S. issued Prop. Reg. §1.707-2 relating to disguised payments for services under Code §707(a)(2)(A). The proposed regulations provide guidance to partnerships and their partners regarding when an arrangement will be treated as a disguised payment for services and not as the issuance of a partnership interest.

The regulations are targeted at cases where a partner performs services for a partnership and the partner would normally get paid a fee in cash, which is taxed as ordinary income. Rather than being paid a fee for services rendered, the partner waives its right to a fee and the partnership makes a special allocation and distribution of the partnership income to that partner, which income is taxed as capital gain since it arises from the sale of stock. This technique allows the partner to get the same amount of cash as he/she would if paid a fee, but the partner is now taxed at capital gains, and not ordinary income, rates. The proposed regulations recharacterize that income as a "guaranteed payment" for services, which is taxed as ordinary income rather than as a carried interest.

The proposed regulations include six nonexclusive factors that may indicate that an arrangement constitutes a disguised payment for services. The most significant factor is the existence of significant entrepreneurial risk and arrangements that lack significant entrepreneurial risk may be treated as disguised payments for services. Additional factors include:

> (1) that the service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration; (2) that the service provider receives an allocation and distribution in a time frame comparable to the time frame that a nonpartner service provider would typically receive payment; (3) that the service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third-party capacity; (4) that the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution; and (5) that the arrangement provides for different allocations or distributions with respect

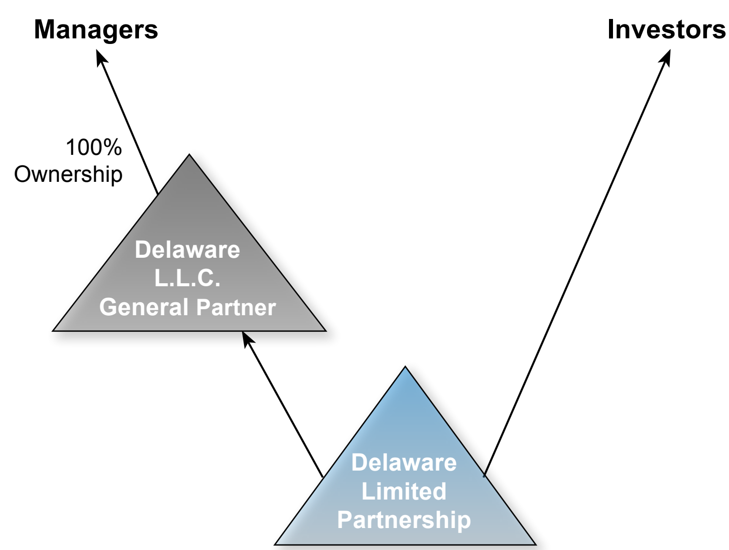
to different services received, where the services are provided by a single person or persons that are related under Code Secs. 707(b) and 267(b), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

While the proposed regulations do not change the treatment of traditional carried interest, the preamble to the regulations states that the I.R.S. may issue further guidance on carried interest when they finalize these regulations. That statement has caused concern as to whether the I.R.S. may change the treatment of carried interest, such as to tax the person who gets the carried interest on receipt.

TYPICAL STRUCTURE

A typical private equity fund structure is as follows:

- The fund is a limited partnership;
- Investors contribute cash to the partnership for common units in the partnership that entitle them to all cash flow until they receive distributions equal to their contributed capital and a preferred return, and after that, 80% of all future cash flow;
- The Manager creates a general partner, which receives a carried interest entitling the Manager to a 20% interest in cash flow after the Investors receive their capital and preferred return;[1] and
- The general partner also receives an annual management fee equal to a percentage of the value of the partnership's assets. Typically, this percentage is 2%.



[1] 20% is the typical amount, however, the rationale behind this amount is not well understood.

NON-U.S. MANAGERS

Managers who are non-resident, non-citizens of the U.S. ("Non-U.S. Mangers") generally pay little or no U.S. federal income tax on income from a carried interest. Foreign persons are not generally subject to U.S. tax on capital gains so long as the gain is not:

- Income effectively connected with a U.S. trade or business ("E.C.I.") that is conducted by the fund, or
- The product of a disposition of a U.S. real property interest ("U.S.R.P.I.").[2]

Thus, the tax treatment of Non-U.S. Managers depends on the income generated by the fund. If the income is capital gain and not from real estate companies, the Manager is generally exempt from U.S. tax. If the income is ordinary income from U.S. sources, there will be a withholding tax of 30% for income that is not E.C.I., such as dividends and interest. This 30% withholding rate is subject to further reduction by international tax treaties or the portfolio interest exemption.[3]

For capital gains and ordinary income that are "effectively connected" with a U.S. business, the Non-U.S. Manager is subject to the same federal income tax brackets as a U.S. person.[4] However, with proper planning, E.C.I. can be avoided.

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2 Code §897(c), Treas. Regs. §§1.897-1 and 1.897-2.

3 Commonly known as "F.D.A.P. Income." Code §§871(h), 882(c), 1441, and 1442.

4 Code §871(b)(I).