

Strafford

presents

Tax Treatment of Equity Compensation for LLC Members

Structuring Equity-Based Interests for Optimal Tax Outcomes

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Leon Andrew Immerman, Partner, **Alston & Bird**, Atlanta
Daniel N. Janich, Officer, **Greensfelder, Hemker & Gale**, Chicago
Christian M. McBurney, Partner, **Nixon Peabody**, Washington, D.C.

Wednesday, September 1, 2010

The conference begins at:

1 pm Eastern

12 pm Central

11 am Mountain

10 am Pacific

You can access the audio portion of the conference on the telephone or by using your computer's speakers.
Please refer to the dial in/ log in instructions emailed to registrants.

For CLE purposes, please let us know how many people are listening at your location by

- closing the notification box
- and typing in the chat box your company name and the number of attendees.
- Then click the blue icon beside the box to send.

For live event only.

- If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.
- If the sound quality is not satisfactory and you are listening via your computer speakers, please dial **1-866-258-2056** and enter your PIN when prompted. Otherwise, please send us a chat or e-mail sound@straffordpub.com immediately so we can address the problem.
- If you dialed in and have any difficulties during the call, press *0 for assistance.

Tax Treatment of Equity Compensation for LLC Members

DANIEL N. JANICH
GREENSFELDER, HEMKER & GALE, P.C.
dnj@greensfelder.com
September 1, 2010

Summary of Presentation

- An Introduction to LLCs
- General Features of an LLC
- Equity Compensation Issues
- Financial Accounting
 - General Rules
 - Valuation
- Income Taxes
 - Grants of LLC Interests
 - Option to Acquire Capital or Profits Interest
 - Section 409A and Equity Interests in LLCs
- LLC vs.. S Corporation
- Related Issues

An Introduction to LLCs

- ◎ LLC is a new type of entity
- ◎ More flexible than corporation
- ◎ Limited liability protection
- ◎ State laws differ

General Features of an LLC

- Legal entity recognized in the U.S. and in most countries around the world
- Governance
 - Similarities to corporations
 - Similarities to partnerships
- Allocation of earnings
- Taxes
 - Income Tax
 - Check the box or not
 - Similar yet different than partnerships
 - States
 - Generally no income taxes
 - Subject to payroll taxes

Equity Compensation Issues

- LLC not a corporation
 - No stock-based programs
 - Member units – similar, but not the same as, corporate shares
- Types of ownership interests
 - Capital interest
 - Profits interest
 - Carried interest
 - Equity Appreciation right
 - Phantom LLC units
 - Profits Interest
- Options → feasible, but not common

Financial Accounting

- Subject to ASC Topic 718 (former FAS 123R)
 - Subject to same rules as stock-based arrangements
 - Equity Interest valued based on fair value
 - Black-Scholes or similar calculations may be necessary for options
 - Purchases of equity interests by employees on similar terms as other investors may not be compensation-related
 - Other accounting rules generally the same as for corporations

- Valuation
 - Difficult
 - AICPA Practice Aid
 - Market-based
 - Income-based
 - Asset-based
 - SEC acceptance for companies undergoing an initial public offering

Financial Accounting

Profits interest

Private company may use fair value or intrinsic value

Mark-to-market (liability accounting)

How LLCs Reward Employees With Equity

- ⦿ LLCs are business organization similar to corporations, but taxed as a partnership
- ⦿ LLCs issue membership interests, not stock
- ⦿ LLCs may issue compensatory equity interests BUT income taxation is uncertain and complex

- ⦿ May Be Primary Reason LLCs Are Often Overlooked As Vehicle By Start Ups

Equity Interests Available in LLCs

- Capital Interests – give owner right to share in value of LLC assets upon sale of LLC
- Profits Interests – owner shares in the profits of the business (and perhaps capital appreciation as well)
- Carried Interests – form of equity used in LLCs engaged in private equity or hedge fund investments; considered a form of profits interest
- Equity Interests in LLCs may be subject to—
 - Fixed or performance-based vesting restrictions
 - Forfeiture for “Bad Boy” conduct

Income Tax Consequences of Granting LLC Interests

- Capital Interest
- Profits Interest and Carried Interest
- Option to Acquire Capital or Profits Interest

Tax Consequences of Granting Capital Interest

- Capital Interest
 - Income recognized upon vesting (Section 83(b) election available)
 - Income = FMV
 - Tax withholding required for income and employment taxes
 - Deduction is recognized when income is recognized
- FMV determined in one of four ways
 - Refer to value of services rendered to LLC
 - Refer to value of capital shifted from existing LLC members to new grantee
 - Refer to value based upon what willing buyer and seller agree to pay in an arm's length transaction
 - Refer to amount employee would receive upon liquidation of LLC at time interest is issued
- Difference between price at vesting and price at sale: short or long term capital gains treatment

Tax Consequences of Granting Profits Interest

- ⦿ Profits interest's tax ramifications are the same for carried interest
- ⦿ Safe Harbor income tax treatment—
 - ⦿ No income tax recognized at any time if three conditions are satisfied:
 - ⦿ Profits interest is received by member or in anticipation of becoming a member
 - ⦿ Profits interest is not related to a substantially certain and predictable stream of income; and
 - ⦿ Profits interest is not sold within two years of receipt
 - ⦿ What happens if the foregoing requirements are not satisfied?
Uncertain whether income tax consequences arise from the initial grant
- ⦿ Section 83(b) election available. But is it needed?
 - ⦿ Refer to value of services rendered to LLC assets
- ⦿ Redemption of profits interest – short or long term capital gain treatment

Tax Consequences of Granting Profits Interest

- ⦿ Profits interest grantees receive annual K-1 statement (without any withholding)
 - ⦿ Responsible for their share of LLC's current income or gains notwithstanding vesting rules which prohibit receipt of distribution
 - ⦿ Treated as "advance" against future distribution of grantee
- ⦿ Grantee must pay
 - ⦿ Estimated income taxes on all income from LLC
 - ⦿ Self-employment taxes on salary

Option to Acquire Capital or Profits Interest

- ⦿ Option grant is alternative to grant of outright interest in LLC
- ⦿ Option grant not taxable to employee or LLC
- ⦿ Exercise of option on capital interest is taxable income for employee and deduction for LLC
- ⦿ Exercise of option on profits interest not taxable for employee and not deductible for LLC

Section 409A and Equity Interests in LLCs

- IRS Notice 2005-1:
 - 409A “may apply to arrangements between a partner and a partnership which provides for a deferral of compensation under a nonqualified compensation plan.”
- LLCs usually are taxable as partnerships
- Notice 2005-1 reference to partnerships is generally understood to also apply to LLCs
- How does Section 409A apply to equity interests in LLCs?
 - Restricted and unrestricted capital interests
 - Profits interest

Section 409A and Equity Interests in LLCs

- ⦿ Restricted and unrestricted capital interests
 - ⦿ Issuance of compensatory capital interest should be treated the same as issuance of stock: no deferral of compensation
 - ⦿ If interest is restricted (vesting schedule), may be subject to 409A (unless Section 83(b) election made)
- ⦿ Profits interest
 - ⦿ Grant of profits interest should be considered exempt from Section 409A – no income is recognized, therefore none can be deferred
 - ⦿ Deferral of annual distributions from a profits interest may be subject to Section 409A

What To Choose: LLC or S Corporation?

- ⦿ Advantages of LLCs
 - ⦿ No ownership limits for LLCs (S Corps limited to 100 owners)
 - ⦿ Any entity or individual may own an LLC interest
 - ⦿ LLC member may be allocated LLC losses in excess of his investment
 - ⦿ Multiple classes of ownership are available
 - ⦿ LLCs may be used to move assets in tax favored ways
 - ⦿ LLCs may readily convert to S or C status
 - ⦿ No entity level state income taxes on LLCs
 - ⦿ Fewer compliance burdens than S and C corporations
 - ⦿ LLCs may provide profits interest to service providers on a tax-free basis

What To Choose: LLC or S Corporation?

- ⦿ Disadvantages of LLCs
 - ⦿ LLCs cannot be acquired on a tax-free basis
 - ⦿ Distribution of profits from LLC generally are subject to self-employment tax (unlike S Corporation)
 - ⦿ Applicable law still developing in LLC world; established and well developed corporate and tax law for S and C corporations
 - ⦿ LLC inventory and accounts receivable are taxed as ordinary income upon company sale, unlike S corporation treatment as capital gains
 - ⦿ LLCs may have trouble attracting venture capital investment

Related Issues

- ⊙ Series LLCs
 - ⊙ Growing usage
 - ⊙ Limited IRS guidance
- ⊙ Sale of LLC units
 - ⊙ Capital interest
 - ⊙ Profits interest
- ⊙ Section 457A may apply to deferred payments
- ⊙ Potential legislation
 - ⊙ Tax Extenders Act (passed in House late 2009)
 - ⊙ Immediate taxation of liquidation value upon granting of carried interests
 - ⊙ No grandfathering
 - ⊙ Substantive changes to both compensation and partnership tax rules
 - ⊙ Earlier legislative proposals are mostly covered in Tax Extenders Act



Tax Treatment of Equity Compensation for LLC Members

L. Andrew Immerman

Alston & Bird LLP

andy.immerman@alston.com

September 1, 2010



Partnership vs. LLC

- In this outline:
 - Any LLC (other than a single-member LLC) is assumed to be classified as a partnership for income tax purposes. So for the most part here:
 - “LLC” and “partnership” are interchangeable.
 - “Member” and “partner” are interchangeable
 - However, a single-member LLC is assumed to be “disregarded” as an entity separate from its owner for income tax purposes (but not for employment tax purposes).



Equity for Services: Corp vs. LLC

- An employee or other service provider is taxable on the receipt (or vesting) of C Corp or S Corp stock as compensation for services.
- A service provider is generally not taxable on receipt (or vesting) of a "profits interest" in an LLC as compensation for services to or for the LLC.

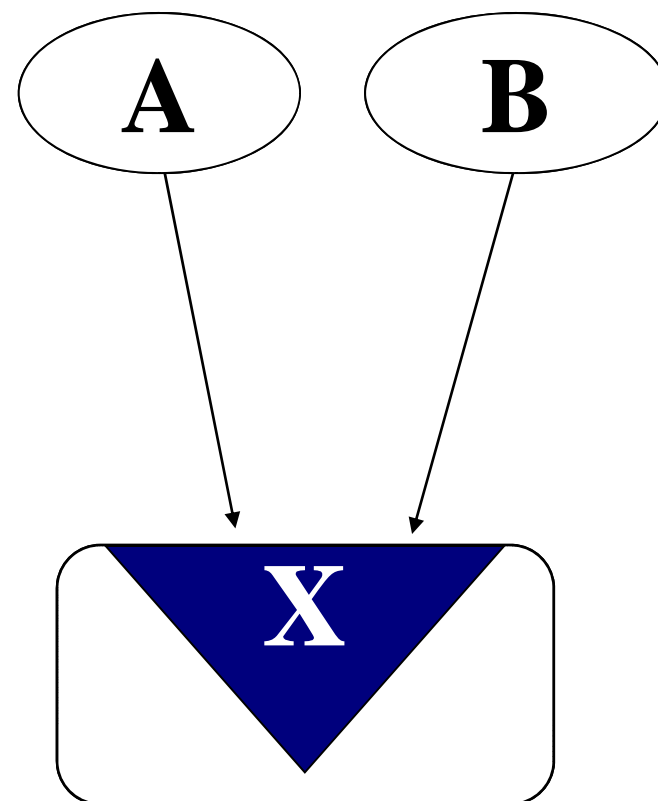
Example: Equity for Services

- A and B form X.
- A contributes property with a fair market value of \$1,000 and a basis of zero.
- B contributes future services that he will perform for X
- A and B share 50/50 in X, except that A has a \$1,000 preference (to be received on the liquidation of X if not before).

FMV = \$1,000

Basis = 0

Services





Equity for Services: X is a Corp

- If X is a corporation:
 - A and B both have taxable gain.
 - A has gain, equal to \$1,000, because he is not in control of X immediately after the exchange (and is not part of an 80% control group). § 351.
 - B has taxable ordinary income equal to the value of his interest in X.
 - Despite A's \$1,000 preference, the value of B's interest could be large.
 - X generally has a deduction for the compensation to B.



Equity for Services: X is an LLC

- If X is an LLC:
 - A has no taxable gain. § 721 (no requirement of 80% control).
 - In general B also will have no taxable gain because he receives only a *profits interest* in X.
 - B's profits interests entitles him to a 50% share of everything (other than the \$1,000 that A put in).



Receipt of Profits Interest

- Rev Proc 93-27, 1993-2 CB 343, defines two types of partnership interests, as determined at time of issuance:
 - *Capital Interest*: Partnership interest that would entitle the holder to a share of liquidation proceeds if partnership assets were sold at FMV.
 - *Profits Interest*: Any partnership interest that is not a capital interest; generally entitles holder only to a share of post-issuance partnership income and gain.



Receipt of Profits Interest

- IRS will accept that the receipt of a profits interest in exchange for services is not a taxable event for the partnership or the recipient, if:
 - The interest isn't related to a substantially certain and predictable stream of income from partnership assets.
 - The interest is not disposed of within two years.
 - The interest is not a limited partnership interest in a publicly traded partnership.



Unvested Profits Interest

- Rev Proc 2001-43, 2001-2 CB 191
- If a partnership grants an unvested profits, the service provider will not be taxed on receipt or vesting if:
 - Conditions of Rev Proc 93-27 are met.
 - Partnership and service provider treat service provider as tax owner of the interest and service provider reports its distributive share of partnership tax items for tax purposes.
 - Upon grant or vesting of the interest, neither partnership nor any partner takes deductions based on the profits interest at grant or vesting.



Safe Harbor vs. Substantive Law

- Rev Proc 93-27 and Rev Proc 2001-43 are safe harbors; follow them and the IRS won't challenge you.
- They are not substantive rules of law
 - However, depart from them and you are thrown back to a confusing mass of authorities.



Grant of Capital Interest

- The grant of a capital interest is considered ordinary taxable income to the service provider.
 - However, the *amount* of income may or may not be the same as the amount of capital that is granted.
 - No clear rule on how much income the service provider has on receiving a capital interest
 - It seems that under current law the income is the “fair market value” of the interest, rather than the amount of capital granted.
 - Partner whose capital is shifted to the service provider may have a deduction.



2005 Proposals

- Proposed regulations under several Code sections, and accompanying proposed revenue procedure, Notice 2005-43, were issued in May 2005. REG-105346-03.
- When effective, they would obsolete current guidance, including Rev Proc 93-27 and Rev Proc 2001-43.
- However, the proposals would generally allow partnerships to achieve essentially the same favorable results as under current guidance, *if* the right elections are made:
 - “Safe harbor” liquidation value election.
 - § 83(b) election for unvested interests.



2005 Proposals: Capital Shift

- The 2005 proposals take the pro-taxpayer position that the members whose capital is shifted to the service provider do not recognize gain. Prop Reg 1.721-1(b)(2)(i) and -1(b)(3).
 - When an employer transfers appreciated property (value in excess of basis) as compensation for services or to satisfy some other obligation, the employer has taxable income (but maybe a compensation deduction as well).
 - Some advisors are skeptical about the 2005 proposals, and still believe that the existing members may recognize gain, essentially the same as if the partnership used appreciated property to pay compensation.
- **Trap:** Even under the 2005 proposals, gain *would be* recognized by the LLC's sole member on the issuance or vesting to a new member of an interest in what was up to that point a “disregarded” LLC.



Final Regulations?

- Treasury reportedly is ***not*** working on finalizing the 2005 proposals.
- Treasury, very sensibly, is waiting to see what Congress comes up with.
- Some LLC agreements are still being drafted to help ensure that, in the unlikely event the 2005 proposals are finalized in their original form, the LLC will be able to get essentially the same treatment that it gets under current law.



Allocations and Distributions

- An LLC distribution is an amount that the LLC member receives.
- An LLC allocation is an amount of profits, losses, or other items that are attributed to the member on the LLC's books.
- Typically -- although there are many exceptions -- the distribution is tax-free and the allocation is taxable.
 - The allocation is taxable whether or not there is a corresponding distribution.
 - It may seem exactly backwards that you can receive distributions tax-free but must pay tax on accounting entries. However, for holders of LLC equity interests, that is the normal pattern.
- Contributions, distributions, and allocations are interrelated concepts.
 - Over the life of the LLC, contributions plus or minus allocations equal distributions.
 - Any time you change one of these items – contributions, distributions, and allocations – you must consider how the others may be affected.



Two LLC Drafting Approaches

- Traditional (layer-cake) allocation.
 - ***Specifies the allocation*** of income and loss.
 - Liquidating distributions are made so as to match allocations.
 - More precisely, the distributions are made in accordance with the capital accounts, which in turn reflect the allocations that have been made.
 - Considered the safer approach under the tax regulations.
 - However, may give the members less certainty about the way liquidating distributions will be made.



Two LLC Drafting Approaches

- Targeted (forced) allocation.
 - ***Specifies the distribution*** of proceeds on liquidation of the LLC.
 - Allocations are made so as to match liquidating distributions.
 - More precisely, allocations are made so that capital accounts (subject to some adjustment) equal the amounts that would be distributed on a liquidation of the LLC at book value.
 - Validity of approach under tax regulations is less clear.
 - However, may give the members more certainty about the way liquidating distributions will be made.
 - This approach requires special care when dealing with profits interests.



Example: Traditional Allocations

- Investors put in \$1,000 and get 50 Class A Units.
- Workers put in services and get 100 Class B Units.
 - 50 Class B Units are issued on the first day of Year One, when the net value of all the LLC's assets is \$1,000.
 - 50 Class B Units are issued on the first day of Year Two, when the net value of all the LLC's assets has increased to \$3,000.
 - Nothing else of relevance occurs during the year (i.e., no capital contributions, distributions, profits, or losses).



Example: Traditional Allocations

- Allocation of Profit and Loss:
 - Allocate profits to offset prior losses.
 - Allocate all remaining profits pro rata by unit.
 - Allocate losses in accordance with capital accounts.
- Before the Year Two Class B Units are issued, the \$2,000 of increased value is treated as profit for purposes of “booking up” (restating) capital accounts of all unit holders.
 - Capital accounts for Class A Units and Year One Class B Units are increased by $\$2,000/100 = \20 per unit.



Example: Traditional Allocations

- Liquidating Distributions:
 - Distribute proceeds in accordance with capital accounts.
- Does this work?
 - Greatly oversimplified, but generally yes.
- On immediate liquidation after the Year Two units are received:
 - Class A Units first get back \$1,000.
 - \$2,000 is distributed pro rata between Class A Units and Year One Class B Units (\$20 per unit).
 - Holders of Year Two Class B Units get nothing.
 - Even if all Class B Units looked the same on the surface, they in fact carried different rights; they were associated with different capital accounts.
 - All Class B Units are profits interests
 - ***However, some Class B Units carry greater distribution rights than others.***



Example: Targeted Allocations

- Same basic facts.
- Investors put in \$1,000 and get 50 Class A Units.
- Workers put in services and get 100 Class B Units.
 - 50 Class B Units are issued on the first day of Year One, when the net value of all the LLC's assets is \$1,000.
 - 50 Class B Units are issued on the first day of Year Two, when the net value of all the LLC's assets has increased to \$3,000.
 - Nothing else of relevance occurs during the year (i.e., no capital contributions, distributions, profits, or losses).



Example: Targeted Allocations

- Allocation of Profit and Loss:
 - Allocate as needed so that capital accounts are equal to the required liquidating distributions.
- \$2,000 of increased value is treated as Profit for purposes of “booking up” (restating) capital accounts of all unit holders, so that capital accounts equal amounts that would be distributed on liquidation.
 - Capital accounts for Class A Units and Class B Units are increased by $\$2,000/150 = \13.33 per unit.
- On liquidation, Class A Units get back their capital, and then all distributions are pro rata by unit.
- Does this work?
 - **No.**



Example: Targeted Allocations

- On liquidation, Class A Units get back any unrecovered capital, and then all distributions are pro rata by unit.
 - Class A Units first get \$1,000.
 - Additional \$2,000 is shared pro rata by *all* units (\$13.33 per unit), including Class B Units issued in Year Two.
- Class B Units issued in Year One are *profits interests*, generally not taxable to the workers on receipt.
 - On immediate liquidation after the units were received, Class B Units would get none of the \$1,000.
 - On liquidation after a year, Class B Units do get \$13.33 per unit.
 - These units were profits interests on grant, and only participated in future growth.



Example: Targeted Allocations

- On these facts, Class B Units issued in Year Two are *capital interests*, generally taxable to the workers.
 - On immediate liquidation after the units are received, these Class B Units get \$13.33 per unit.
 - The right to receive proceeds on a liquidation is the definition of a capital interest.
 - Class B Units issued in Year Two are capital interests; they share in a liquidating distribution even if there are no future profits or growth.
 - All Class B Units had equal distribution rights, but the Year Two Class B Units were taxable capital interests.



Example: Targeted Allocations

- Class B Units issued in Year Two should have had lower distribution rights than Class B Units issued in Year One, the same as in the traditional allocation example.
- It is possible to use targeted allocations even when workers receive profits interests at different times, but use care.
 - For example, LLC could have granted only “Class C Units” in Year Two, and provided that Class C Units only share in liquidating distributions over \$3,000.
- ***Regardless of the allocation method, or the labels that are given to the units, profits interests granted at widely different times normally will not have the exact same rights to receive LLC distributions.***



Carried Interest Legislation Update

September 1, 2010

Tax Treatment of Equity Compensation
for LLC Members

Christian McBurney, Partner

NIXON PEABODY_{LLP}
ATTORNEYS AT LAW

What is a Carried Interest?

- Legislation to add new IRC section 710
- A Carried Interest is broadly defined to include any partnership interest:
 - not related to a qualified capital investment
 - held by a person who performs specified investment manager services for a financial investment partnership
- Private Equity / Hedge Fund Managers structure funds with a 2 & 20 compensation structure
 - new rule would apply to the 20% carry

Carried Interest in Real Estate

- Often referred to as “the promote,” “the sponsor’s share,” or the “back-end piece”
- Recognizes the benefit to the partnership of the guarantee of debt/other liabilities
- Often not realized until after meeting “the hurdle” rate
- Does not include fees for leasing, management, construction and other services which are separate and treated as ordinary income

The Legislative Timeline

2007 – Introduction

- Legislation introduced by Rep. Sander Levin (D-MI)
- Hearings held in House and Senate
- Passed the House as an offset for temporary tax extenders

2008 – Passed by the House

- Passed the House as an offset for AMT Relief
- Senate declined to consider legislation

2009 – Passed by the House

- Passed the House as an offset for temporary tax extenders
- Senate held off consideration for larger tax reform debate

2010 – Passed by the House

- Passed the House as part of “the American Jobs and Closing Tax Loopholes Act of 2010”
- Senate unable to move legislation forward (by 3 votes)
- Senate passed unemployment benefits extension only

Current Carried Interest Tax Proposals

- Effective Date: Taxable years after 12/31/2010
- Applies to old and new partnerships (no grandfathering)
- Applies to persons (or related persons) who:
 - Directly or indirectly provide any of the following services with respect to assets held (directly or indirectly) by the partnership:
 - Advising on investing in, purchasing, or selling a “specified asset”
 - Managing, acquiring, or disposing of a specified asset
 - Arranging financing with respect to a specified asset; or
 - Any activity in support of any of the previously described activities

52

Definition of Specified Assets

- The term “specified asset” means:
 - Securities (section 475(c)(2))
 - Real estate held for rental or investment
 - Partnership interests
 - Commodities (section 475(e)(2))
 - Options or derivative contracts with respect to these assets

Some Partnerships Covered Include:

- private equity funds
- hedge funds
- venture capital funds
- LBO funds
- real estate funds and partnerships
- marketable securities funds and partnerships
- oil and gas funds and partnerships???

Some Partnerships Not Covered:

- Partnership operates an active business
 - E.g., profits interests are issued to service providers by an LLC that operates a manufacturing business
- Partnership operates a real estate business subdividing lots, building houses on them, and selling the houses and lots (ordinary income generated)
- Partnership that holds a farm used for farming purposes, if the partnership is held by members of the same family

Blended Rate Applies for Individual Partners Some Differences Between the House Bill and the Senate Proposal:

	House Bill	Senate Proposal
% Ordinary Income in Years Beginning Before 1/1/2013	50%	75%
% Ordinary Income in Years Beginning on or After 1/1/2013	75%	75%
Sale or Exchange of Assets Held at least 5 years, in Years Beginning on or After 1/1/2013	75% (50% phase-in)	50%
Sale or Other Disposition of Interests of Fund Manager Entities held at least 5 years (“Enterprise Value”)	75% (50% phase-in)	50%

Other Consequences

- Net income and net loss generally is treated as ordinary
- Where an individual is engaged in the trade or business of providing specified services, income taken into account as ordinary income would become subject to self-employment tax
 - This is regardless of whether the partner is a limited partner and regardless of whether the underlying partnership income would be exempt from self-employment tax (e.g., dividends, interest, capital gain)

Tax Acceleration

Tax on Carried Interest is accelerated if:

- Carried Interest holder transfers Carried Interest (even transfers to family partnerships or REIT operating partnerships)
- Carried Interest holder receives property distributions from the partnership
- Partnership merges into another partnership

In limited cases the Carried Interest holder can elect to avoid the gain if the Carried Interest taint is carried over to the new partnership (e.g., a partnership merger, division or termination under section 708(b)(1)(B))

Loss Limitation Rule

- Tax losses otherwise flowing through 75% / 50% tainted portion of Carried Interest are deferred and can only be used against future Carried Interest income from that specific partnership
- The idea is that Carried Interest is compensation income and should not receive tax losses like an investment
- Under current law, real estate developers often receive tax losses because they are at risk for debt-guarantees, but this legislation would limit the developer's losses

Corporate / REIT Impact

- **No Exemption for Corporations**
 - Although C corporation's pay the same tax rate for ordinary income and capital gain, the loss deferral rules, income acceleration rules, and general character matching rules could have substantial impact
- **REIT impact**
 - Not intended to change income qualification for REITs
 - Could significantly increase REIT distribution requirements because tied to taxable income which is increased by income acceleration/loss deferral rules
 - Risk of loss deferral for down-REIT partnerships
 - Special rule for publicly traded partnerships

Qualified Capital Exception

- Carried Interest holder can exclude “Qualified Capital” that is acquired for invested capital and intended to be the “side-by-side” capital such holder puts in with the investors
- To apply the rule, there must be an unrelated investor who contributes cash in exchange for a capital interest on the same basis as the Carried Interest holder
- One exception: Carried Interest rule does not apply if all allocations, distributions and capital contributions have been pro rata

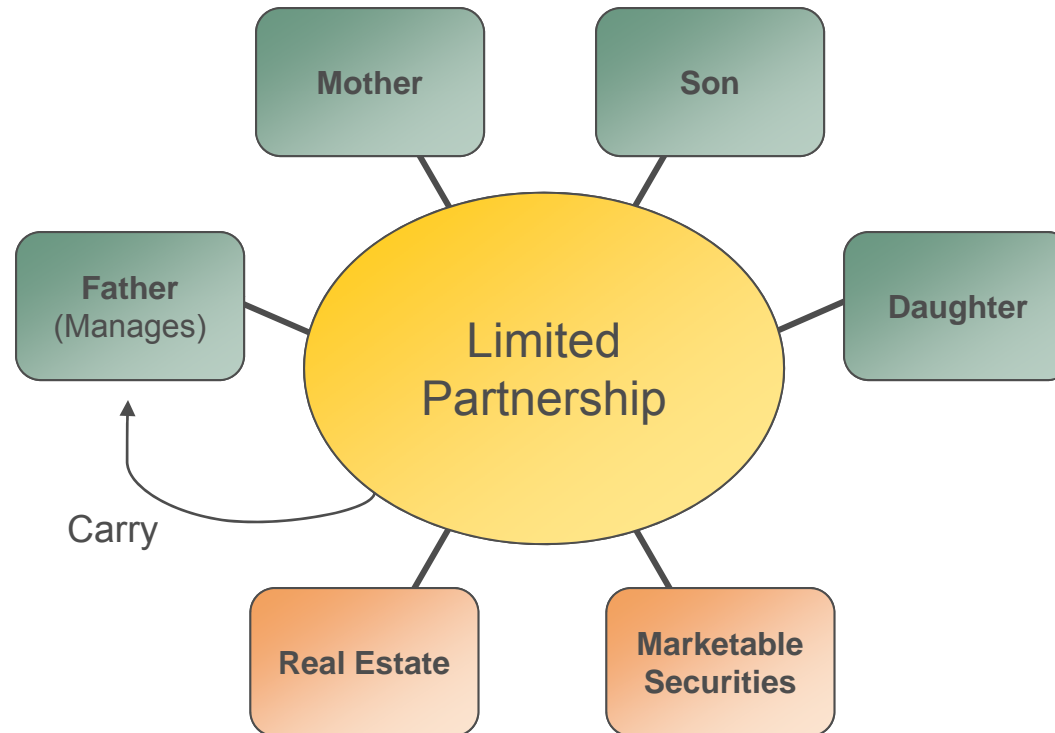
Qualified Capital Exception - Loans

- Carried Interest holder will not be treated as having a Qualified Capital Interest to the extent that contributed capital is attributable to a loan made or guaranteed, directly or indirectly, by any other partner or the partnership (or a person related to such partner or the partnership)
- Other loans to Carried Interest holder are not disqualified

Unintended Consequences of Legislation

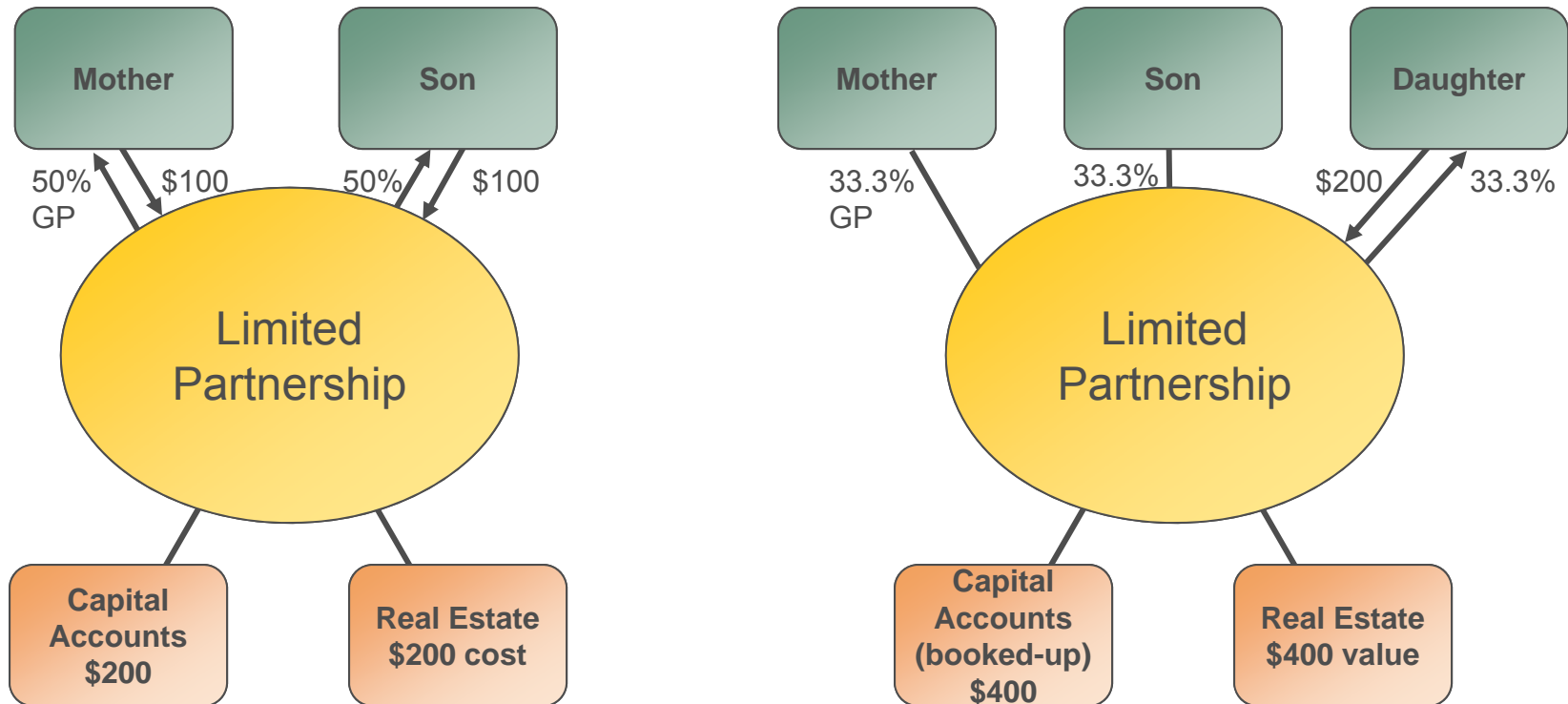
- Much of the recent attention to the carried interest legislation has been on its unintended broad applications to partnerships that have nothing to do with hedge, private equity, venture capital, or real estate funds. For example, due to a quirk in the rules, all partners of a family partnership investing in real estate or marketable securities could be subject to the rule converting capital gains to ordinary income. In addition, there is a loss limitation rule that could apply to partnerships of related parties, even if there are no profits. It is also not clear why the legislation should apply to C corporations. See following examples.

Family Partnership



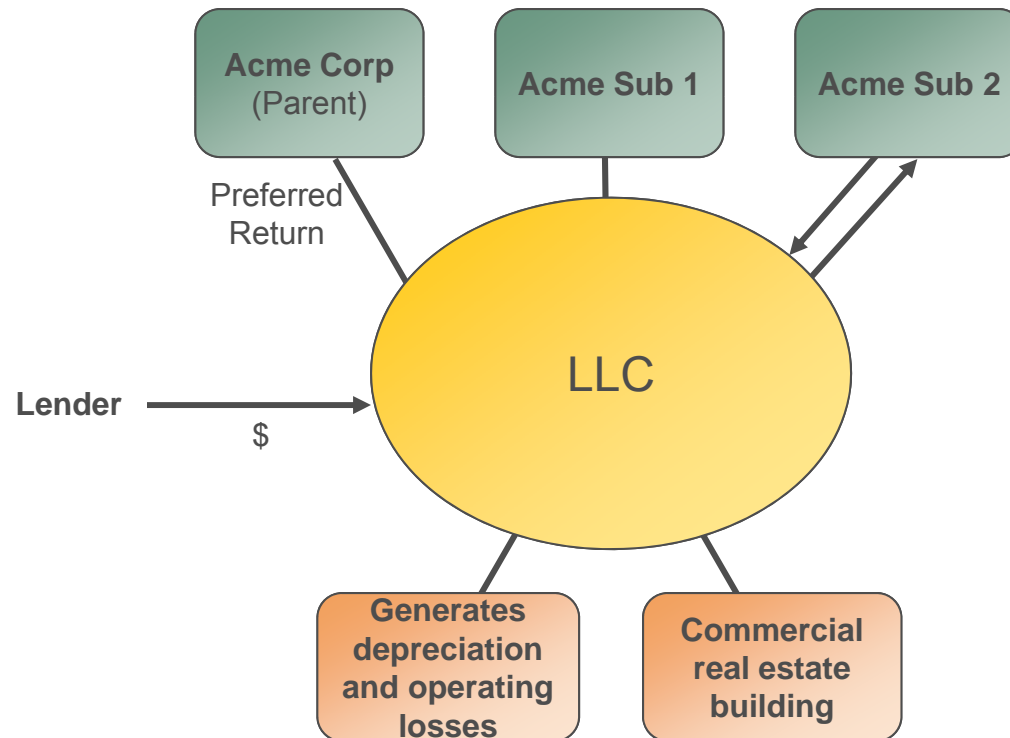
- No Qualified Capital Interests?
- Pro Rata allocations, distributions and capital contributions?
- Each partner subject to ordinary income treatment?

Family Partnership (II)



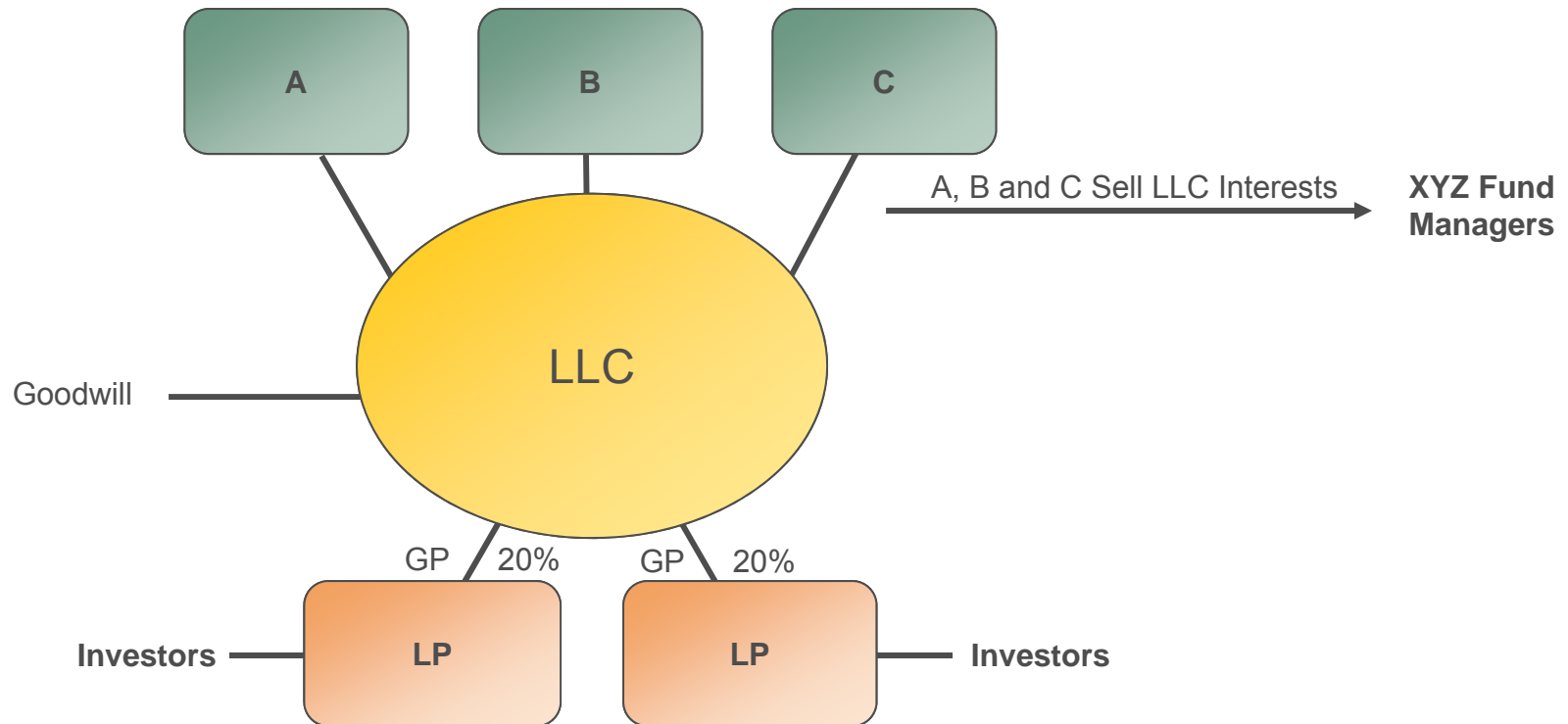
- Capital contribution based on capital account balances does not satisfy the “pro rata” exception!

Affiliated Group of C Corporations



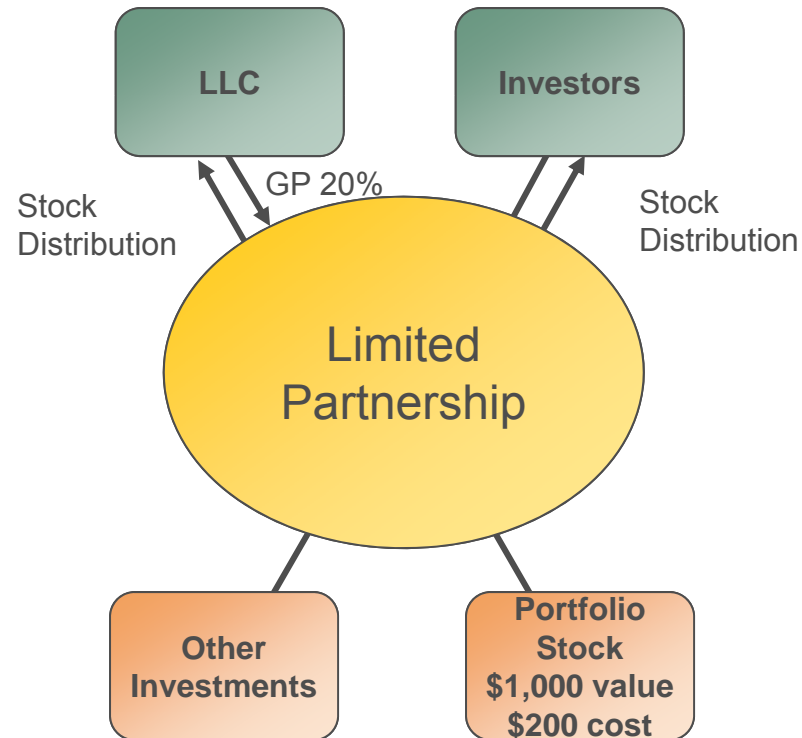
- Loss limitation rule applies for all members!
- Income acceleration rules could later apply!
- Why does statute apply to C Corps?

Sale of Interests in Fund Manager Entity



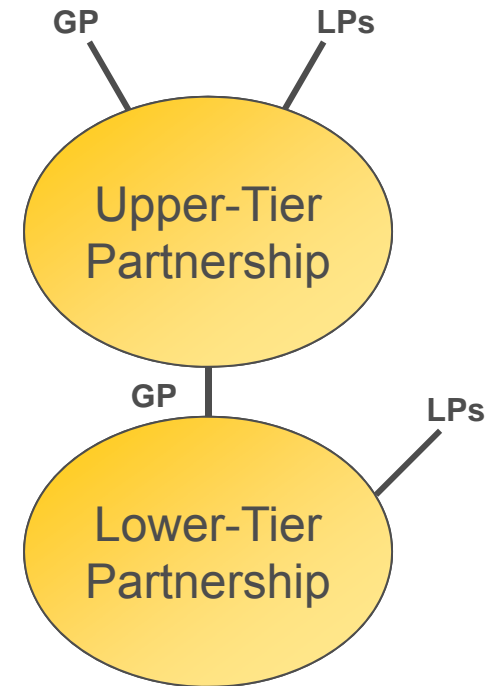
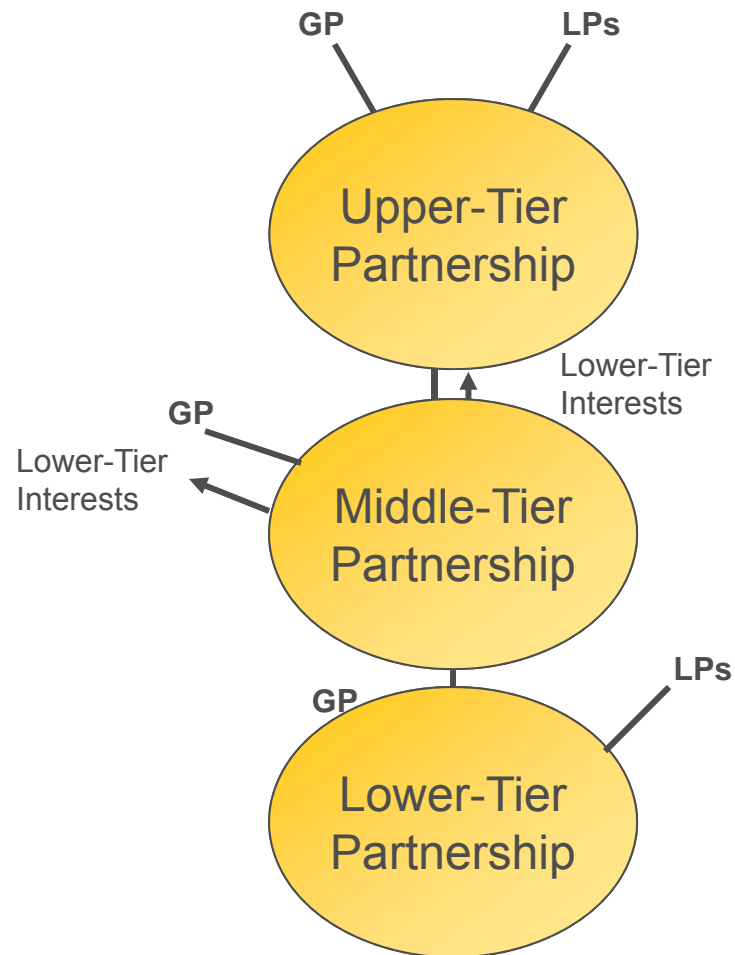
- 75% of gain treated as ordinary income
- Senate Proposal: if interests held 5 years or more, 50% of gain treated as ordinary income

Transfer of Property to Carried Interests



- Distribution to GP triggers ordinary income treatment

Eliminating Middle-Tier Partnership



- On distribution of lower-tier partnership interests, built-in gain is accelerated!

What to do Now?

- Review and amend as needed tax distribution provisions, since legislation if passed would increase tax rate for some but not all partners
- In new deals: separate out a manager's Carried Interest and Qualified Capital Interest
- In existing deals: have work done to separate two classes and consider amending LLC Agreement
- Senate bill would give credit for Qualified Capital to the extent that a loan is repaid before the date of enactment

Disclaimer

Any tax advice in this presentation is not intended to be used for the purpose of avoiding tax penalties. The information contained is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax advisor.