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The Introduction of House and Senate Bills Confirms that Congress May Change the Tax Rules for Hedge Funds and Private Equity Funds

Introduction

The introduction on June 21, 2007, of the Levin-Rangel carried interests bill and on June 14, 2007, of the Baucus-Grassley “Blackstone Bill,”¹ has intensified concern that the Congressional tax committees may change the tax rules for hedge funds and private equity funds (collectively, “private funds”) and their managers. Those who care about possible changes need to get involved now if they want to have any chance of affecting forthcoming legislation.

Background

There are two principal forces at work. First, Congress needs revenue. The Democrats have, as promised, reinstated the “pay-as-you-go” budget rules, which require that any tax cuts Congress passes be offset by tax increases (or spending cuts).² Although many Congressional Democrats may be skeptical about broadly extending the tax cuts enacted in 2001 and 2003, members of the tax committees support a host of more targeted tax cuts, including education tax incentives, energy tax incentives, and relief from the alternative minimum tax.

When it comes to proposals for offsetting the revenue reduction that would result from such tax cuts, most of the “low-hanging fruit” already has been picked. Specifically, the recently enacted bill that increased the minimum wage also provided modest tax incentives for businesses, and the cost of these incentives was offset by eight revenue raising provisions, which made modest changes such as increasing various penalties.³ To raise further revenue, the Congressional tax committees either have to turn to existing proposals that are quite controversial, such as proposals to codify the economic substance doctrine⁴ or reduce tax

¹ H.R. 2834, 110th Cong. (2007); S. 1624, 110th Cong. (2007).

² Section 201 of the Congressional Budget Resolution for fiscal year 2008 provides that “it shall not be in order in the Senate to consider any direct spending or revenue legislation that would increase the on-budget deficit or cause an on-budget deficit for” fiscal 2008 or the inclusive five and ten year periods; it also provides that the point of order can be waived by a vote of three-fifths of the Senators. S. Con. Res. 21, 110th Cong. (2007).

³ U.S. Troop Readiness, Veterans’ Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007, Pub. L. 110-28 The eight provisions are estimated to raise a total of \$4.4 billion over ten years. See above Joint Committee on Taxation Report dated May 25, 2007, at 2, available at <http://www.house.gov/jct/x-30-07.pdf>.

⁴ In the previous Congress, the Senate repeatedly passed a proposal that would clarify and expand the “economic substance” doctrine for determining whether a transaction’s formal structure should be disregarded for tax purposes. The proposal was estimated to raise revenue by approximately \$15 billion over ten years. Report of the Senate Committee on Finance accompanying Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006

benefits for executive compensation,⁵ or else they have to come up with some new ideas.

That's where private funds come in. The second factor at work is increasing concern among tax policy makers about whether private funds are properly taxed; this overlaps with a more general concern about the perceived increased concentration of wealth and reduced progressivity of the tax code.

The most notable criticism of the current tax treatment of private funds was in a law review article by Victor Fleischer, a law professor at the University of Illinois. Fleischer's article, entitled "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," argues that "[c]hanges in the investment world—the growth of private equity funds, the adoption of portable alpha strategies by institutional investors, the increased capital gains preference, and more sophisticated tax planning—suggest that reconsideration of the partnership profits puzzle is overdue."⁶ Fleischer focuses on "carried interest"—the general or managing partners' interest in fund profits, and he suggests several possible changes to the tax rules, including treating carried interest allocations as ordinary income regardless of the underlying character of the fund's income, eliminating deferral by requiring realization at the time that carried interests are received (notwithstanding valuation issues), or imposing a cost of capital charge on managers. Other criticisms, of the treatment of carried interests or more generally of the application of the tax rules to private funds, have been published in *Tax Notes*, a magazine closely read by the Congressional tax staffs.⁷

(S. 1321) (September 15, 2006), S. Rep. No. 109-336, 109th Cong., at 138.

⁵ As part of its original version of the minimum wage/business tax incentive bill considered early in 2007, the Senate passed a provision that would deny tax deferral for nonqualified deferred compensation that exceeded either \$1 million or the individual's average compensation over the previous five years. Fair Minimum Wage Act of 2007, H.R. 2 (as amended by the Senate), 110th Cong., Section 226.

⁶ Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," Legal Studies Research Paper Series Working Paper Number 06-27 March 2006 Revised June 12, 2007 (forthcoming N.Y.U. L. REV. 2008), at 6-7.

⁷ See Lee A. Sheppard, "Hedge Fund Managers' 15 Percent Tax on 20 Percent of the Profits," *Tax Notes*, Mar. 27, 2006, p. 1380, Doc 2006-568, 2006 TNT 59-5.

There is considerable evidence that key members of Congress and their staffs have been paying close attention to such criticisms. The staffs of the Congressional tax committees recently convened a roundtable discussion at which Professor Fleischer and others discussed issues relating to private funds,⁸ and, at a recent Finance Committee hearing, the Ranking Republican Member of the Committee, Senator Charles Grassley (R-IO), pointedly asked a Treasury Department witness whether Treasury was reviewing the tax treatment of hedge funds.⁹

Thus, the two forces are converging: a Congress looking for ways to raise revenue without broadly raising taxes is closely examining the appropriate tax rules for private funds and their managers. The two recent bills to result from this examination – the carried interest bill and the "Blackstone Bill" – are discussed below.

The Levin-Rangel Carried Interest Bill

On June 21, 2007, a senior member of the House Ways and Means Committee, Congressman Sander Levin (D-MI), along with the Chairman of the Ways and Means Committee, Congressman Charles Rangel (D-NY) and several others, introduced legislation, H.R. 2834, that, in essence, treats carried interests as ordinary income. In introducing the bill, Congressman Levin said: "Investment fund employees should not pay a lower rate of tax on their compensation for services than other Americans. These investment managers are being paid to provide a service to their

⁸ See Wesley Elmore, "Baucus Sees No Rush to Act on Hedge Fund Legislation," *Tax Notes*, May 8, 2007, available at <http://www.taxanalysts.com>, Doc 2007-11048, 2007 TNT 89-1.

⁹ On April 18, 2007, the Finance Committee held a hearing on the "tax gap." At the hearing, Senator Grassley told Treasury Secretary Henry Paulson that "I think that there is a lot going on in the hedge fund industry that might help us with the tax gap as well." He asked Secretary Paulson whether the Treasury Department was reviewing the tax policy implications of hedge funds. Secretary Paulson deferred to Assistant Secretary for Tax Policy Eric Solomon, who said: "we are looking at these issues, and I know that the IRS is looking at these issues." *Examining the Administration's Plan for Reducing the Tax Gap: What are the Goals, Benchmarks and Timetables?: Hearing Before the Sen. Fin. Comm.*, 110th Cong., audio available at <http://www.senate.gov/~finance/sitepages/hearings.htm> (follow 4-18-07 hyperlink to view hearing).

limited partners and fairness requires they be taxed at the rates applicable to service income just as any other American worker.”

Specifically, the bill amends subchapter K to add a new section that treats income from an “investment services partnership interest” as ordinary income. An “investment services partnership interest” is defined as any person’s interest in a partnership if that person provides, directly or indirectly, in an active conduct of a trade or business, a substantial quantity of any of four categories of services (or if that person provides any activity in support of such services). The four categories of services are:

- (1) advising the partnership as to the value of any specified asset;
- (2) advising the partnership as to the advisability of investing in, purchasing, or selling any specified asset;
- (3) managing, acquiring, or disposing of any specified asset; or
- (4) arranging financing with respect to acquiring specified assets.

The term “specified assets” includes securities within the meaning of section 475(c)(2) (but including contracts marked to market under section 1256), real estate, commodities within the meaning of section 475(e)(2), or options or derivative contracts with respect to such securities, real estate, or commodities.

The bill provides an exception for cases in which a portion of an investment services partnership interest is acquired on account of a contribution of capital, but only if the partnership makes a reasonable allocation of partnership items between the portions of the distributive shares that are and are not with respect to invested capital. For this purpose, an allocation is not considered reasonable if it would result in the partnership allocating a greater portion of income to invested capital than any other partner not providing services would have been allocated with respect to the same amount of capital.

The bill generally permits losses with respect to an investment services partnership interest to be recognized (as ordinary losses) to the extent of prior income with respect to the interest, and requires gain and loss on the disposition of such an interest to be

treated as ordinary (with losses subject to a similar limitation). Although partnerships may generally defer tax on assets distributed in-kind to partners, the bill would require a partnership to recognize gain on any assets distributed in-kind to the holder of an investment services partnership interest. The bill provides an exception for investment services partnership interests held by real estate investment trusts.

Interestingly, the bill does not expressly establish an effective date, so the general rule would apply, making the bill’s provisions effective upon enactment.

The Blackstone Bill

One week before the introduction of the carried interest bill, Congress first began acting on its examination of the tax rules for private funds and their managers with the introduction of the so-called “Blackstone Bill.” On May 21, 2007, the Blackstone Group LP announced that it planned to raise as much as \$4.75 billion by becoming a publicly traded partnership (“PTP”). Blackstone’s initial filings with the Securities and Exchange Commission indicated that Blackstone expected to qualify for continued treatment as a partnership (rather than as a corporation) under tax code section 7704(c), which provides that, to avoid taxation as a corporation, a PTP must earn 90 percent or more of its gross income in the form of “qualifying income,” which includes interest, dividends, rents, gain from the sale of a capital asset held for the production of income, and gain from commodities contracts. Blackstone earns income that would not be qualifying income—such as management fees from the funds that Blackstone manages—through a corporate “blocker” subsidiary, which can then pay qualifying dividends to Blackstone. Although the subsidiary pays corporate-level tax on its income, it allows the remainder of Blackstone’s income—primarily its carried interests in the funds—to escape any corporate-level tax.

The Chairman of the Senate Finance Committee, Senator Max Baucus (D-MT), along with Senator Grassley, responded. On June 14, 2007, they sent a letter to Treasury Secretary Henry Paulson, describing the Blackstone IPO and saying that “[w]e believe that the PTP rules are being circumvented because the majority of the income is from the active provisions of services to the underlying funds and limited

partner investors in those funds.”¹⁰ Accordingly, that same day, Senators Baucus and Grassley introduced legislation, S. 1624, that would modify the test under section 7704(c). Specifically, the bill would prohibit any PTP from relying on the qualifying income exception (and thus would require the PTP to be taxed as a corporation) if the PTP directly or indirectly has any item of income from “services provided by any person as an investment advisor ... or as a person associated with an investment advisor” or from “asset management services provided by any [such person or related person] in connection with the management of assets with respect to which [such] services were provided.”¹¹ The explanation of the bill makes clear that the reference to income earned “directly or indirectly” by the partnership would include a dividend paid by a corporation (such as the Blackstone blocker subsidiary) that has such an item of income.

Notably, the bill’s general effective date is the date of introduction (June 14, 2007), except for a five-year grace period for partnerships that were already publicly traded or had already filed registration statements as of that date. Thus, although the bill appears to have been inspired by the Blackstone IPO, Blackstone (but not its IPO imitators) would have the benefit of the delayed effective date. The effective date continues a long-standing practice of preventing a “rush to market” by making bills aimed at complex

¹⁰ Letter from Senators Max Baucus and Charles Grassley to Treasury Secretary Henry Paulson dated June 14, 2007, available at <http://www.senate.gov/~finance/sitespages/baucus.htm> (follow “6-14-07 Baucus-Grassley Bill Addresses Publicly Traded Partnerships,” at 2-3).

¹¹ S. 1624, § 1(a).6 (amending IRC § 7704(c) to add new paragraph (4)).

corporate transactions effective at the first point that the business community has been given formal notice of the intended change.¹²

Although the Blackstone Bill is concerned with private equity managers that attempt to continue to be taxed as partnerships after publicly offering their shares, the broad language of the bill could apply in other contexts. Funds and other entities that rely on the qualifying income exception thus should also pay close attention to this legislation.

Need To Act Now

Those who would be affected by modifications to the tax treatment of private funds need to become actively engaged now. The best way to influence the outcome is to get in early, educate staff and Members of Congress about the potential impact of their proposals, identify allies, and, where appropriate, develop alternative proposals that respond to legitimate concerns in a way that minimizes the potential adverse economic impact.

Please let us know if you would like us to keep you apprised of developments or want to get involved more actively to protect your interest. Lawyers in our Washington, D.C., office, including former counsels on the Senate Finance Committee and the House Ways and Means Committee, closely follow the work of the tax committees. Please contact your K&L Gates relationship partner or the author of this alert, whose phone number is listed on the front page.

¹² Another recent example is the corporate inversion provisions enacted in 2004, which were made effective on the date on which the Senate Finance Committee held a hearing on inversions. See Code § 7874 (a)(2)(B)(i).

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