

# Although Changes in Law are Possible, Changes to Fund Compensation Structures are Premature

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*Since the first publication of this article, President Obama has announced in his budget proposal for Fiscal Year 2010 his support for carried interest being taxed at ordinary income rates, beginning in 2011; however, the authors of this article believe that the message expressed here still stands.*

Recent press articles suggest that private investment fund sponsors should restructure the way “carried interest” is paid in their funds in order to avoid or lessen the impact of potential changes in tax law previously announced by President Barack Obama. In our view, any such changes are premature and could lock fund sponsors into adverse economic arrangements or have adverse tax effects if implemented before any such legislation is passed.

## Overview of Proposed Changes

President Obama has indicated that he would support increased taxes on carried interest in line with legislation proposed by Rep. Sander Levin (D-MI). Rep. Levin’s bill generally treats carried interest as ordinary income to the recipient, regardless of the underlying character of the income that generated the carried interest. The bill contains limited exceptions which would not apply to the vast majority of funds, as they are currently structured. Subsequently, Rep. Charles Rangel (D-NY) introduced legislation containing provisions similar to (and more restrictive than) Rep. Levin’s bill. Neither bill was acted upon by the Senate. It is possible, given the current composition of Congress, that a bill similar to one of these bills will be reintroduced in Congress in 2009; however, given the current economic environment, it is uncertain what appetite Congress and President Obama will have in the short-term for tax raises.

## Summary of Recently Publicized Proposals

Recent press coverage has identified at least two changes to fund structures suggested by certain practitioners to neutralize changes similar to those proposed in Rep. Levin’s bill. It should be noted, however, that neither suggested approach would be viable under the legislation introduced by Rep. Rangel.

**Loan Approach.** The first approach would require limited partners in funds (or perhaps the fund itself) to loan the carried interest recipient (typically the general partner of a fund), on a nonrecourse basis, an amount equal to the carried interest percentage of the fund’s capital (typically 20 percent of capital). The fund sponsor would then invest into the fund the loaned capital. The concept is that the carried interest would be converted from a profits interest, earned on limited partner capital, into a return on the fund sponsor’s invested capital (loaned to it by the

limited partners), a return which would be exempted from Rep. Levin's bill (but not from Rep. Rangel's bill). This loan would need to carry adequate interest, which the fund sponsor would be required to pay on a current basis (otherwise, income would be imputed to the fund sponsor).

This approach could work under Rep. Levin's bill, at least on a superficial basis; however, the loan would need to be a bona fide loan for tax purposes, which generally would require (among other things) that the fund sponsor has sufficient assets for the limited partners to reasonably expect repayment. In addition, fund sponsors would need to include income on a current basis and would not necessarily be entitled to a deduction for interest paid on such a loan, even if the invested loaned capital were ultimately lost.

Finally, as discussed above, Rep. Rangel's bill would appear to eliminate this planning opportunity. Of course, it is impossible to know at this time whether any legislation would resemble Rep. Rangel's or Rep. Levin's proposed legislation.

**Offshore Approach.** The second approach involves either establishing an offshore corporation through which the fund sponsor holds its carried interest or organizing the actual investment fund as an offshore corporation. Typically this corporation would be located in a low- or no-tax jurisdiction. There are many variations on this structure, some of which require minority US ownership to avoid another set of punitive tax rules applicable to so-called "controlled foreign corporations". Other such structures would require payment of carried interest as a fee, rather than as an allocation of profits. Such structures could result in deferral of tax, and, in certain unique circumstances, retention of capital gains treatment for carried interest; however, such structures could require significant changes to funds' operating procedures (including in some cases relocation of significant personnel outside the United States) or would require fund sponsors to keep cash proceeds from the carried interest outside the United States for a significant period of time (we note in this regard that we have seen in press articles advocacy of organizing the investment fund as a "passive foreign investment company"—however, under Rep. Rangel's bill, such an approach would not result in capital gains treatment for carried interest).

Depending on the form final legislation takes, there may be other approaches fund sponsors could take to restructure the way in which carried interest is paid in their funds to ensure continuing capital gains treatment for the carried interest or to otherwise mitigate the tax effects of legislation. In our view, however, implementing these, or the approaches discussed above, is premature at this point. First, the form of any legislation on carried interest is unknown at this time and the available planning approaches will differ dramatically depending on whether such legislation tracks Rep. Levin's proposal or Rep. Rangel's proposal. Second, it is arguable whether any legislation will be enacted in the short-term, given the current economic climate. Third, the approaches outlined above, as well as other possible alternatives, if implemented today, would lock fund sponsors into immediate tax (in the case of the loan structure) or inflexible structures requiring ongoing maintenance and potentially moving personnel offshore (such as the offshore structure).

## **Conclusion**

It is premature to reorganize fund structures today in light of the tremendous uncertainty concerning the new administration's legislative priorities and the effect of the economic crisis on those priorities and the details of legislation that will emerge. While it could be prudent to adopt some of the structures discussed above if legislation similar to Rep. Levin's bill were enacted, at this point nobody knows with any degree of certainty, what, if any, legislation will be enacted in 2009.