WEIL GOTSHAL

Private Equity Alert

Special Edition
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Weil News

- Weil Gotshal expanded its funds practice in Asia by adding fund formation partner John Fadely to its Hong Kong office
- Weil Gotshal lawyers Joe Basile, Ron Landen and Rose Constance were awarded a Burton Award for Legal Writing for their article "Equitable (In)subordination – Considerations for Sponsors Lending to Portfolio Companies" which first appeared in the September 2009 issue of our Private Equity Alert
- Weil Gotshal advised Oak Hill Capital in connection with its $570 million acquisition of restaurant and entertainment chain Dave & Busters
- Weil Gotshal advised Lee Equity Partners in connection with its acquisition of "take and bake" pizza chain Papa Murphys
- Weil Gotshal advised OMERS Private Equity in connection with its acquisition of United States Infrastructure Corporation, a provider of locating and marketing services for underground utilities
- Weil Gotshal advised Advent International on its acquisition of DFS Furniture Company, the UK's leading sofa retailer
- Weil Gotshal advised Advent International on its sale of Poundland, Europe's largest single price discount retailer
- Weil Gotshal advised Hg Capital in its acquisition of Frosunda, a Swedish disability care services company

Carried Interest Legislation Introduced in the House of Representatives and Senate

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On May 20, 2010, Senator Max Baucus and Congressman Sander Levin released the "American Jobs and Closing Tax Loopholes Act" (the "Proposed Legislation") as a proposed amendment to the tax extenders bill, H.R. 4213. The Proposed Legislation includes a provision to tax carried interest as ordinary income. The Proposed Legislation's carried interest provisions are similar to previously introduced (but not enacted) proposals to tax carried interest as ordinary income, the most recent of which was passed by the House of Representatives in December 2009. Please see our prior Private Equity Alerts (December 2009, July 2009 and July 2007), where we discussed those earlier proposals.

Consistent with the previous proposals, the Proposed Legislation regarding carried interest is limited to "investment services partnership interests" (the "Interests"). For purposes of the Proposed Legislation, an Interest is likely to include certain partnership or limited liability company profits interests issued in exchange for services (e.g., "pass-through over C corporation" profits interests issued to management) as well as typical carried interest arrangements of private equity, hedge, venture capital and real estate investment fund sponsors, and management fee waiver programs of such fund sponsors.

If the Proposed Legislation is enacted in its present form, net income with respect to an Interest will be treated as ordinary income (limited, in the case of individuals, to a specified percentage), and, to the extent of such previous ordinary income inclusions, any allowed net losses will be treated as ordinary losses. The specified percentage is 50% for any tax year beginning on or prior to December 31, 2012 and 75% for any tax year beginning thereafter. Moreover, the Proposed Legislation would tax gain from the disposition of an Interest (to the extent of the specified percentage, in the case of individuals) as ordinary income in certain circumstances *even if the disposition transaction would otherwise have been nontaxable*.

The effective date of the Proposed Legislation is generally the date of enactment, subject to a special rule that net income attributable to a partner's Interest in the taxable year of enactment will be equal to the lesser of (i) the net income in respect of such Interest for the entire taxable year and (ii) the net income in respect of such Interest from the date of enactment through the end of such taxable year.[1]

As described above, certain dispositions of Interests after the date of enactment may no longer be effected on a fully tax free-basis. For example, this may impair the

ability of certain private equity portfolio companies, including "pass-through over C corporation" portfolio companies, to incorporate (or effect an IPO) post-enactment on a fully tax-free basis to the holders of Interests. Appropriate planning may therefore be of interest, on a time-sensitive basis, to the owners of such private equity portfolio companies. Under appropriate circumstances, incorporating (which may be accomplished by means of a tax election) a pass-through entity that owns a portfolio company prior to enactment of the Proposed Legislation may be beneficial.

The Proposed Legislation includes some notable changes from the most recent carried interest proposal that was passed by the House in December 2009.

- Allocations to qualified capital interests (e.g., an interest in a partnership that is attributable to the fair market value of property or money that was contributed to the partnership) will not be recharacterized as ordinary income provided that (i) such allocations are made in the same manner as allocations made to other qualified capital interests held by non-service partners and (ii) the allocations made to such non-service partners are significant compared to the allocations made to the service partners. Previously proposed versions of this legislation empowered the Secretary to provide relief in certain circumstances where a partnership has no or only insignificant allocations to nonservice partners. The Proposed Legislation expands this authority to also apply relief to only "portions" of a qualified capital interest as well as in the circumstance where a partnership fails to meet (ii) above merely because the allocations to qualified capital interests owned by service partners represents a lower return than the allocations to other qualified capital interests.
- Allocations to qualified capital interests in a lower-tier partnership retain such character to the extent allocated on the basis of qualified capital interests in any upper-tier partnership.
- An Interest will not fail to qualify as a qualified capital interest solely because allocations made by the partnership to such interest do not reflect the cost of services provided by the interest holder to the partnership (e.g., self-charged carried interest and management fee). Thus, unless otherwise provided in regulations, the failure to have GP capital bear carried interest or management fees should not disqualify that capital interest.
- Adjustments to qualified capital interests are required (based on regulations or other guidance to be issued by the Secretary) when such interests are issued in exchange for contributions of property whose fair market value is not equal to the adjusted basis of such property immediately prior to such contribution. It is unclear exactly what this means, but the language of this provision suggests that some percentage of the resulting contribution may be deemed non-qualified.
- A partnership interest may become an Interest subject to the Proposed Legislation in the future if the holder of the interest provides investment services to the partnership after acquiring such interest even if the partner did not reasonably expect to provide such services on the date that it first acquired its partnership interest.
- An exception to the requirement that gain is recognized on the disposition of an Interest is available for (i) contributions of an Interest to an entity classified as a partnership for U.S. federal income tax purposes and (ii) the distribution of an Interest in connection with certain partnership terminations, mergers and divisions provided that, in each case, an election is made and certain record keeping and reporting requirements are satisfied.
- Individuals disposing of Interests in "publicly traded partnerships" are not subject to the proposed legislation provided they (or any member of their family) have not at any time provided any "investment services" with respect to any of the assets held by such publicly traded partnership. As drafted, this provision does not appear to relieve such holders from taxation at ordinary income rates on their distributive share of investment services partnership income realized by the partnership itself.

The House and Senate are discussing the Proposed Legislation and may vote on it beginning as early as this week, although as we go to press, the process is encountering delays. If you have any questions about the foregoing, or would like to discuss how the Proposed Legislation may impact your particular circumstances, please contact Robert Frastai (robert.frastai@weil.com, or 212 310 8788), Joseph Newberg (joseph.newberg@weil.com, or 617 772 8350), Michael Nissan (michael.nissan@weil.com, or 212 310 8169), Stan Ramsay (stan.ramsay@weil.com, or 212 310 8011) or Russell Stein (russell.stein@weil.com, or 617 772 8322.)

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1 In addition, the income from an Interest held by a publicly traded partnership will be classified as "non-qualified" income for purposes of the publicly traded partnership rules beginning 10 years after the date of enactment. However, as the Proposed Legislation is presently drafted, the recharacterization to ordinary income would apparently commence on enactment.

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