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September 24, 2008

Rep. Charles B. Rangel, Chair
House Ways and Means Committee
U.S. House of Representatives
Washington, DC 20515

Rep. Jim McCrery, Ranking Minority
House Ways and Means Committee
U.S. House of Representatives
Washington, DC 20515

Sen. Max Baucus, Chair
Senate Finance Committee
U.S. Senate
Washington, DC 20510

Sen. Charles E. Grassley, Ranking Minority
Senate Finance Committee
U.S. Senate
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The Honorable Eric Solomon
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The Honorable Douglas Shulman
Commissioner
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Joint Committee on Taxation
Professional Staff
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Re: **Report on Proposed Carried Interest and Fee Deferral Legislation**

Dear Sirs:

We write to recommend changes to section 710 of H.R. 6275 and section 457A of H.R. 6049 and S. 3335. Section 710 would tax the service element of the "carried interest" of certain investment partnerships as ordinary compensation income. Section 457A would prohibit most deferrals of compensation by U.S. managers who provide services to certain "tax-indifferent" partnerships or foreign corporations.

We express no view on the policy question of whether the service element of a profits interest issued by an investment partnership should be taxed as ordinary income. Nor do we express any view on the policy question of whether taxpayers who provide services on behalf of a "tax indifferent" employer should be prohibited from deferring their compensation income. Instead, we assume that Congress will adopt some form of both of these provisions. Therefore, we raise several technical issues presented by the provisions and suggest possible solutions.

In short, we recommend that:

- Invested Capital. Under section 710, the portion of a service provider's distributive share that is treated as attributable to "invested capital" is exempt from recharacterization and therefore remains taxable to the service provider in accordance with its underlying character. However, invested capital is defined narrowly to include only the fair market value of any money or other property contributed to the partnership. Congress should expand the definition of "invested capital" to reflect not only the cash and the fair market value of any property contributed to a partnership, but also amounts credited (or debited) to the book capital account of the service provider to reflect (i) recognized taxable income or loss and (ii) distributions of cash or other property to the partners. In addition, future regulations should allow an adjustment to invested capital to reflect any unrealized gain or loss relating to the invested capital when another partner contributes additional capital to the partnership or when the partnership makes a disproportionate distribution to a partner.

- Reconciliation with Section 83. In connection with an enactment of section 710, Congress should amend section 83 of the Internal Revenue Code either to compel or permit the use of "liquidation value" as the sole appraisal methodology for valuing the initial grant of an investment services partnership interest (an "ISPI"). If the ISPI in question is a "capital interest" rather than a "profits interest," the grantee should receive "invested capital" credit under section 710 in an amount equal to the income reportable as compensation upon grant or vesting. If Congress declines to amend section 83 as we recommend, it should nevertheless cap any invested capital credit to the service provider under proposed section 710 at the liquidation value of the ISPI upon grant or vesting.

- Allocations of Income to Invested Capital. A service provider's distributive share of income will qualify as attributable to invested capital only if the partnership makes a "reasonable allocation" of partnership items to invested capital. If any portion of an allocation is not reasonable, section 710 appears to disqualify the entire allocation. Moreover, an allocation is "per se" unreasonable if it results in the partnership allocating a greater portion of income to the service provider's invested capital than to the invested capital of any other partner that does not provide services.

Congress should modify the manner in which proposed section 710 apportions the service provider's income between invested capital and services in two respects:

- first, Congress should eliminate the "cliff" effect associated with unreasonable allocations of income to invested capital, and treat only the excess portion of the allocation as ordinary income for services, and

- second, Congress should either eliminate or temper the severity of the "per se" unreasonable rule. As presently drafted, this rule will place the service provider in an inferior tax position vis-à-vis a similarly-situated non-service partner who contributes a like amount of invested capital, and is therefore a poor proxy for establishing the portion of the service provider's income that represents taxable compensation for services.

- Exclude Operating Partnerships. The intended target of proposed section 710 is clear – service providers engaged in the asset management business who report their share of the income from the managed investments as capital gains. However, section 710 may inadvertently apply to other operating partnerships that are not the targets of the legislation. Congress should revise section 710 to ensure that it captures the intended targets of the legislation, but excludes operating partnerships and other unintended targets. One possible mechanism for doing so is to limit the application of the Bill to partnerships with "specified assets" that represent a substantial percentage of the partnership's total assets. If such a minimum threshold test is adopted, we also recommend an anti-abuse rule that would permit Treasury in appropriate cases to either aggregate assets of multiple related partnerships or disaggregate assets within a single partnership. Any asset-based test should also grant relief to a partnership that is not a "financial buyer" of the type described in the legislative history, but rather operates a strategic business through one or more corporate subsidiaries.

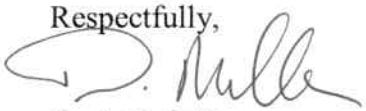
- Broad Grant of Regulatory Authority. Congress should accompany any legislative proposal in this area with a broad grant of regulatory authority.

- Fee Deferrals. Section 457A would exempt any deferral arrangement with a treaty-eligible foreign employer. As currently drafted, service providers for foreign investment funds may be able to establish fee deferrals through treaty jurisdictions even though the investment fund itself is not actually subject to significant foreign tax and is therefore just as indifferent to the timing of the compensation deduction as a fund domiciled in a tax haven. Therefore, we recommend that Congress revise section 457A to require the foreign employer to actually bear "comprehensive foreign income tax" in the treaty jurisdiction.

We also raise a number of other technical issues that these proposals will present, together with possible solutions.

We appreciate your consideration of our report. Please let us know if you would like to discuss these matters further or if we can assist you in any other way.

Respectfully,



David S. Miller

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