

message from partner in charge

This year we started the *New York Update* newsletter with the idea of giving our clients and friends insights into a wide variety of legal issues that may affect their businesses. Our final issue of the year certainly fits that bill.

While the Middle East remains the hot bed of fossil fuel transactions, our lead article gives a glimpse in to the new “green” technology fronts emerging in the land of oil and sand. Not surprisingly, solar energy is leading the charge, capitalizing on the most well known energy element not buried beneath the desert earth.

Authored by Pepper partner Steve Bortnick, our second article breaks down new proposals born out of the Temporary Tax Relief Act passed by the House of Representatives on November 9, 2007. The proposals targets offshore deferred compensation and carried interests. The new proposals will add section 475A to the Internal Revenue Code.

Happy Holidays!

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Green Gulf

This article first appeared in The Deal Newsweekly special report on Alternative Energy in the Middle East on September 17, 2007.

Private equity (PE) investment in the Middle East, particularly in the Cooperation Council for the Arab States of the Gulf, is a relatively new phenomenon.

Between 1994 and 2005, more than \$4 billion of PE funds were raised in the six Gulf Cooperation Council (GCC) markets: United Arab Emirates, Kuwait, Qatar, Bahrain, Oman and Saudi Arabia. Forty percent of that \$4 billion was raised in 2005 alone.

According to a recent report prepared by the Gulf Venture Capital Association in collaboration with KPMG, the region's PE industry will break the \$10 billion mark in fundraising by the end of 2007, due largely to the surge in oil prices. This has provided GCC countries with ample liquidity that has enabled them to embark on a large-scale remodeling of their respective economies. Historically, GCC countries have been almost entirely dependent on the oil sector.

The GCC governments are further capitalizing on their liquidity by enhancing their financial sectors, opening their markets to international competition, encouraging privatization and expanding massive infrastructure projects, all of which have enhanced opportunities for PE investment in alternative energy projects.

For instance, the United Arab Emirates has taken steps to develop “green” solutions to energy production. Abu Dhabi launched the Masdar Initiative, focusing on the development and commercialization of technologies for renewable energy, energy efficiency, carbon management and monetization, water usage and desalination. This multibillion-dollar initiative is designed to ensure that Abu Dhabi participates in the global energy market beyond just carbon-based fuels.

To power massive water desalination needs, the region has sought energy sources other than fossil fuels, which

is generally reserved for export. The Masdar Initiative, a unique endeavor in the region, has created a \$250 million Clean Technology Fund. Masdar has begun construction of a special economic zone, a “city within a city,” that will offer incentives to investors and developers of renewable energy technologies and products. These incentives will include transparent laws, 100 percent foreign ownership, a tax-free environment, intellectual property protection and proximity to nearby manufacturers, suppliers and markets. The zone will house one of the world’s largest solar energy farms, using the region’s natural conditions as a source for considerable solar energy production.

Until recently, it remained unclear whether PE firms in the Middle East would join the alternative energy and cleantech boom. The Dubai-based GCC Energy Fund has taken the initial step as the region’s first buyout fund focused on the energy sector. Launched in 2005, the fund is sponsored by Gulf International Bank BSC and Standard Bank, along with the Emirates National Oil Co. Ltd. The firm has already announced traditional and alternative energy investments in Maritime Industrial Services Co. Ltd., the purchase of a stake in Stellar Energy Middle East, the acquisition of a controlling interest in Dhofar Power Co. and the purchase of an equity stake in the Gulmar Offshore Group. The success the fund has achieved in such a short period is attracting regional and international PE firms to the Middle East energy sector.

The regional investment in clean technologies, driven by policies seeking greenhouse gas emission reductions and

diversification of energy supply, also has given rise to often-overlooked equity opportunities in the nascent carbon trading market.

As signatories to the Kyoto Protocol, certain GCC states can market carbon credits generated by projects that reduce greenhouse gas emissions under the United Nations’ Clean Development Mechanism. While qualifying for credits is a complex legal undertaking, those who pioneer in the current carbon market as a component of their at-large renewable energy investment strategy will have a considerable advantage over their competitors in the Middle East and other financial hubs.

The Middle East is fertile ground for PE firms seeking to expand their alternative energy and cleantech portfolios. As with all investment strategies, success is composed of calculated risk and risk protection. While the environment is right for energy sector investment in the Middle East, PE firms must partner with knowledgeable players in the marketplace who have an ability to protect an investor’s interest at every stage of business.

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The Hon. Spencer Abraham



Peppercast: Religious Discrimination in the Workplace

Few issues are as personal and potentially divisive as religion. In this podcast, **Robert Ludolph**, a partner in the Detroit office of Pepper Hamilton and chairman of the Detroit office’s Labor and Employment Practice Group, discusses religious discrimination in the workplace, including how employers can deal with claims from employees that an employer did not accommodate their religious practices or beliefs and claims asserting religious harassment.

If you are interested in the latest updates in the world of labor and employment, e-mail podcasts@pepperlaw.com to subscribe to *Pepper@Work*. This is an electronic news alert that provides employers with advice on how recent labor judgments and opinions will affect their organization.

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Proposal Targets Offshore Deferred Compensation and Carried Interests

The latest attack on investment fund managers' carried interests came on November 9, 2007, when the House passed the Temporary Tax Relief Act. The bill is targeted at patching the Alternative Minimum Tax (AMT), which in its current iteration is anticipated to hit 23 million U.S. households. Members of the House stated that they would only pass a fix to the AMT, on a pay-go basis, i.e., by including revenue raisers sufficient to cover the \$50 billion of revenue lost by patching the AMT. Accordingly, the bill includes two significant revenue raisers that would impact investment fund managers.

The first revenue raiser would add new section 475A to the Internal Revenue Code. Broadly, this provision would require the current taxation of deferred compensation from certain tax indifferent parties. The second revenue raiser provides for the taxation of carried interests at ordinary income rates.

Carried Interests

Carried interests can come in a variety of forms. The carried interest in the form of a partnership profits interest, or the right to a share of the appreciation in the partnership assets, has been the subject of most of the publicity and legislative proposals. Fund managers who hold these carried interests generally count on the flowthrough nature of a partnership to generate income that is taxed largely at long-term capital gain rates. When the fund is a corporation for U.S. tax purposes, capital gains derived by the fund would not flow through as capital gains. In the case of an offshore fund classified as a corporation for U.S. tax purposes, the carry generally is in the form of an incentive fee that may be deferred by the manager. Generally, these funds are formed in tax haven jurisdictions, such as the Cayman Islands. Subject to certain restrictions, the manager can expect significant tax savings as a result of this deferral.

Even under current law, the fund manager has to navigate special rules in order to defer management fees. The manager cannot be in constructive receipt of the fee. Accordingly, the manager and the fund have to agree to the deferral before the period for which the services are performed. Once deferred, the manager generally cannot have the right to accelerate payment of the fee. Additionally, the fee gen-

erally cannot be set aside in an account protected from the fund's creditors. Moreover, Section 409A provides other restrictions that, if not followed, may result in acceleration of income and the imposition of an excise tax.

Proposed Section 475A

Proposed Section 475A restricts the ability to defer tax on compensation paid to a service provider by a nonqualified foreign entity pursuant to a nonqualified deferred compensation plan. Where applicable, the service provider would be required to include in income all deferred compensation at the time that the right to such compensation is not subject to a substantial risk of forfeiture. A manager's right to the compensation is only subject to a substantial risk of forfeiture if such right is conditioned upon the performance of substantial services in the future.

Nonqualified foreign entities are defined as (1) foreign corporations unless substantially all of their income is subject to tax in the U.S. because it is effectively connected with a trade or business in the U.S. or subject to a comprehensive foreign income tax; and (2) any partnership unless substantially all of its income is allocable to persons other than foreign persons not subject to a comprehensive foreign income tax and tax-exempt organizations. In short, a foreign entity will be a nonqualified foreign entity unless it (or, in the case of a partnership, its partners) are subject to U.S. or comprehensive foreign income taxes. This requires further explanation. A foreign person would be considered to be subject to a comprehensive foreign income tax only if the person is eligible for the benefits of a comprehensive income tax treaty with the U.S. or demonstrates to the Treasury that the foreign country has a comprehensive income tax. In each case, the foreign country's tax must have rules regarding the deductibility of deferred compensation similar to those in the Internal Revenue Code.

If a taxpayer receives deferred compensation under a nonqualified deferred compensation plan from a nonqualified entity and such amount cannot be reasonably ascertained at the time awarded, proposed Section 475A imposes an interest charge on the amount ultimately ascertained through the date such amount is ascertained, plus an additional tax equal to 20 percent of the amount of the compensation. Both the interest charge and the 20 percent tax

must be paid in addition to the taxpayer's ordinary income tax rate of 35 percent. It is unclear whether this provision is intended to reach the portion of the deferred fees that are considered to be reinvested in the fund, or just those considered reinvested in illiquid assets of a fund. In either case, these provisions treat a fund manager who defers fees from offshore funds worse than had the manager been paid the fees in cash and reinvested the proceeds.

Proposed Section 475A generally applies to deferred income for services performed after December 31, 2007. However, if the income would be deferred beyond tax years beginning before 2017, such deferred income would be includable in income in the last taxable year beginning before 2017. The proposal does require Treasury to come up with rules that would permit, for some limited time, the acceleration of income from services performed before 2008 to pre-2017 periods without violating Section 409A.

Depending on the meaning of "ascertainable," which is not clear from the language of the statute, many investment fund managers may be subject to the 20 percent additional tax and interest charge under Section 475A. Investment fund deferred compensation arrangements providing for reinvestment of deferred amounts or subjecting deferred compensation to the attainment of certain performance criteria may cause such deferred compensation to have no ascertainable value until the end of the deferral period. Accordingly, at the end of the deferral period the investment fund manager would be subject to the interest charge and the additional 20 percent tax.

Modifications of the Proposals to Tax Carry as Ordinary Income

As mentioned above, the proposals in the latest bill to tax carry as ordinary income from the performance of services are very similar to the earlier proposals. However, there are some important modifications worth mentioning here. The latest proposal would preclude avoidance of their reach by having investors or the partnership make or guarantee loans to the manager to purchase an interest in the partnership. They also would preclude avoidance by having the investors make loans instead of capital contributions to the partnership. Additionally, gain on options, derivatives and convertible and contingent debt the value of which is substantially related to the amount of income or gain from assets with respect to which the manager provides investment management services will be treated as ordinary income for the performance of services. Finally, the new proposal modifies the penalty provisions, including increasing to 40 percent the penalty for any understatement

relating to the rules on convertibles and derivatives or the regulations implemented to prevent avoidance of these provisions and making the exception for understatements as a result of reasonable cause unavailable to such understatements. Moreover, the proposal would be retroactive to tax years ending (or certain events occurring) after November 1, 2007.

Perspective

A big question is whether the AMT patch can be implemented without the revenue from the provisions described above. On November 1, Senator Charles Grassley said that the measure will have to be amended to remove changes to carried interest taxation and the proposed Section 475A. Treasury Secretary Henry Paulson requested that Congress pass any change to the AMT by early November, to allow the IRS sufficient time to create and make available the necessary tax return forms for the 2008 filing season.

Even if the Senate prevails and the provisions are not included as part of the AMT patch, these provisions still may be enacted as part of legislation during 2008. It is our understanding that the deferred compensation provision has even more support than the carried interest provisions.

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