WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

U.S. REPRESENTATIVE SANDER LEVIN REINTRODUCES LEGISLATION TAXING CARRIED INTERESTS OF FUND MANAGERS AT ORDINARY INCOME TAX RATES AND RESTRICTING USE OF PUBLICLY TRADED INVESTMENT MANAGEMENT PARTNERSHIPS

On April 2, 2009, U.S. Representative Sander Levin (D-MI) reintroduced legislation that would apply ordinary income tax rates to carried profit interests from hedge funds, private equity funds, venture capital funds and other investment partnerships and restrict the use of publicly traded investment management partnerships. Currently, investment managers entitled to preferential partnership allocations of investment fund profit (called "carried interests") generally receive allocations that retain the character of the partnership's own income and realized gains. As investment fund partnerships often realize significant capital gains, such allocated income is often capital in character, resulting in a low tax rate. The legislation would subject income earned from these carried interests to a maximum current income tax rate of 35 percent and to self-employment tax.

The taxation of carried interests has increasingly been the target of legislative proposals. Similar legislation was proposed by Representative Levin and other members of Congress in 2007 and 2008, and President Obama has included taxing carried interests at ordinary rates in the Administration's 2010 budget.

By its language, the legislation would apply to an "investment services partnership interest," defined as an interest in a partnership issued to a partner in connection with that partner's performance of services if at the time of issuance of the interest the partner or a related person was reasonably expected to provide, directly or indirectly, a "substantial quantity" of certain services, including (a) advising as to the advisability of investing in, purchasing or selling securities, investment real estate, interests in other partnerships, commodities, options or derivatives, (b) managing, acquiring or disposing of such assets, (c) arranging financing for the acquisition of such assets, and (d) performing any activity in support of these services. Unlike previous proposals, this legislation does not require that the partner be performing these services in the active conduct of a trade or business.

Under the Levin proposal, a partner's distributive share of partnership items would be recharacterized as ordinary income or loss, as would any gain or loss if the partner disposes of the investment fund interest. Such allocated ordinary income would be subject to self-employment tax. Allocated ordinary losses would be deductible to the extent of previously allocated income less previously allocated net losses, with excess amounts deferred into future years. Any deferred losses would be extinguished upon partnership liquidation or transfer of the partnership interest. If an investment partnership were to distribute property with respect to an investment services partnership interest, the partner would be taxed at ordinary income tax rates on any unrealized appreciation.

However, under certain circumstances, ordinary tax rates would not apply to allocations made with respect to the portion of an investment services partnership interest that is a "qualified capital interest," defined as the portion of an interest attributable to (a) the value of any money or property contributed in exchange for the interest, plus (b) any amounts included in gross income as compensation at the time of the transfer of the partnership interest to the partner, plus (or minus) (c) any net income (or net loss) previously allocated to the interest after enactment of the proposal, less (d) any distributions to the partner. A qualified capital interest does not include an interest acquired in connection with the proceeds of any loan made or guaranteed by the partnership or any partner. Profits and losses allocated to a qualified capital interest would retain their character (as long-term capital gains, short-term capital gains, etc.) and would not be recharacterized as ordinary income or losses if the allocation were made in the same manner as allocations (of "significant" magnitude) made to other qualified capital interests held by non-service provider partners. As compared to previous versions of the proposal, which had explicitly required that no "greater portion of income" be allocated to the service partner's capital interest, this version uses more ambiguous language (income needs to be allocated "in the same manner"); however, it remains unclear without further clarification whether a capital interest subject to a lesser or no management fee and/or profit allocation may be considered a qualified capital interest.

This proposal adds a provision not included in earlier versions but suggested by commentators that the granting of a partnership interest for investment services to the partnership should be valued for compensation purposes at the liquidation value of the interest, unless the partner elects otherwise.

This proposal would also subject publicly traded investment management partnerships to the tax rules for corporations. Several investment managers have undergone public offerings but have avoided being subject to corporate tax and have maintained their flow-through partnership status. A publicly traded partnership is entitled to flow-through partnership status if 90 percent or more of its annual income is qualifying investment income. This legislation would treat allocated income from investment services partnership interests as not qualifying for this purpose. However, the proposal would not apply to certain partnerships owned by real estate investment trusts and certain partnerships that own other partnerships. Currently existing partnerships would be granted a ten-year grace period.

The legislation also applies to an investment manager's synthetic equity interest in an investment fund or other entity (not necessarily a partnership) if the value of the interest is "substantially related" to income or gain from assets with respect to which the investment management services are being performed, with an exception for "qualified capital interests" similar to the one described above. As listed, such synthetic interests include convertible or contingent debt, an option to acquire such debt, a derivative instrument entered into with the entity or an investor in the entity, and "any interest" other than debt in such an entity, or an option to acquire such an interest. This provision would not apply to a partnership interest, stock in a "taxable corporation," or S corporation stock but would apply to stock in a foreign corporation (such as an offshore fund) unless substantially all of the foreign corporation's income is either effectively connected to a U.S. trade or business or subject to a comprehensive foreign income tax.

Also, the proposal provides that if a tax sharing agreement applies to the transfer of a partnership interest, such that the transferee would make a payment to the transferor of an amount determined with respect to a tax benefit realized by the transferee from the depreciation or amortization of an asset included in the transfer, the partners will be treated as related under certain tax rules, which would cause recharacterization from capital to ordinary of certain amounts of gain realized on such a transfer.

The proposal does not specifically indicate whether allocations of carried interest would be considered as either "effectively connected income" for investment managers who are not U.S. persons or "unrelated business taxable income" for U.S. tax-exempts receiving allocations from carried interests.

The proposal would subject those who violate the above rules and underreport their tax liability to penalties of 40 percent of any underpayment of tax with no "reasonable cause" exception available. The proposed effective date of the provisions has not been included in the current draft.

* * * * * * * * * * * * * * *

If you have any questions regarding this memorandum, please contact Joseph A. Riley (212-728-8715, jriley@willkie.com), James R. Brown (212-728-8287, jbrown@willkie.com), Richard L. Reinhold (212-728-8292, rreinhold@willkie.com), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

April 9, 2009

IRS Circular 230 disclosure:

To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Copyright © 2009 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.