Seward & Kissel LLP

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MEMORANDUM TO OUR CLIENTS

SUMMARY OF PROPOSED LEGISLATION THAT WOULD IMPACT MANAGERS OF PRIVATE INVESTMENT FUNDS AND TAX-EXEMPT INVESTORS IN SUCH FUNDS

On November 1, 2007, the House Ways and Means Committee passed the "Temporary Tax Relief Act of 2007" (the "Act"), the primary purpose of which is to prevent a significant increase in the number of taxpayers subject to the alternative minimum tax (the "AMT"). The Act also contains a number of revenue-raising provisions which, if enacted into law, would have a significant impact on the general partners and investment managers (collectively, the "Managers") of private investment funds (collectively, "Funds") and the investment by U.S. tax-exempt entities ("U.S. Tax-Exempts") in Funds treated as partnerships for federal income tax purposes ("Investment Partnerships"). The fate of the Act remains uncertain as both Treasury Secretary Paulson and congressional Republicans have expressed their opposition to the revenue-raising aspects of the Act.

The Act includes provisions regarding (1) the tax treatment of the "carried interests" derived by Managers for the long-term capital gains realized by the Investment Partnerships with respect to which they are general partners, (2) the ability of Managers of Funds formed as corporations in foreign jurisdictions ("Offshore Funds") to defer the taxation of the fee income they derive from the performance of investment management services for Offshore Funds, and (3) the ability of U.S. Tax-Exempts to invest in an Investment Partnership to avoid the realization of "unrelated business taxable income" ("UBTI") solely through the Investment Partnership's use of borrowed funds.

Taxation of "Carried Interest" as Ordinary Compensation Income

Under current law, the "carried interest" derived by Managers that are partners in an Investment Partnership (i.e., an allocation of an Investment Partnership's income that is disproportionate to the capital invested by the Manager in the Investment Partnership) has the same federal income tax characterization (e.g., capital gain or ordinary income) as the tax character of the income derived by the Investment Partnership. Under the Act, the "carried interest" income derived by a Manager of an Investment Partnership would be treated as compensation income taxable at ordinary income tax rates. (As compensation income, such income would also be subject to self-employment tax.) As under current law, the portion, if any, of the "carried interest" attributable to the Investment Partnership's unrealized gains would not be subject to tax until such gains are realized. The Act provides, however, that partnership "flow-through" tax treatment would continue to apply to the extent a Manager's income from an Investment Partnership represents a reasonable return on capital it has actually invested in the Investment Partnership. In addition, under the Act, any gain derived by a Manager on the disposition of its equity interest in an Investment Partnership (other than the portion of gain attributable to the Manager's invested capital) would be treated as ordinary income, rather than as capital gain.

The proposed legislation would apply to taxable years ending after November 1, 2007. With respect to the 2007 calendar year, the amount of the net income to which the new rules would apply would be treated as the lesser of (i) the net income for the entire calendar year, or (ii) net income determined by only taking into account items attributable to the portion of the year which is after November 1, 2007. Although not entirely clear, it appears that, if the proposed legislation is enacted in its present form, a Manager's share of an Investment Partnership's realized capital gains attributable to securities sold by the Investment Partnership subsequent to November 1, 2007 would be treated as ordinary income (even if much of the appreciation in the value of the securities accrued in years prior to 2007), but the Manager's share of realized capital gains attributable to securities sold on or before November 1, 2007 would be treated as capital gains.

Deferral of Fee Income from Offshore Funds

Many Managers who provide services to Offshore Funds pursuant to investment management agreements historically have relied upon the general rules governing the taxation of nonqualified deferred compensation to defer the taxation of all or a portion of the fees payable to them by the Offshore Funds. The Act would effectively eliminate the ability of Managers to defer their fee income derived from services performed for Offshore Funds by taxing such fee income at such time as there is no "substantial risk of forfeiture." For this purpose, a Manager's rights to receive compensation would be treated as subject to a "substantial risk of forfeiture" only if the Manager's rights to such compensation are conditioned upon the performance of substantial services by the Manager.

The proposed legislation would apply to amounts deferred which are attributable to services performed after December 31, 2007. However, the proposed legislation also provides that deferred amounts in respect of earlier years effectively cannot be deferred beyond 2016.

Investments by U.S. Tax-Exempts in Investment Partnerships

Under current law, U.S. Tax-Exempts that invest in an Investment Partnership derive UBTI (which is taxable to the U.S. Tax-Exempts) from the Investment Partnership's receipt of certain items of income related to its portfolio investments. In particular, the portion of a U.S. Tax-Exempt's share of an Investment Partnership's income and gains that is attributable to the use of borrowed funds by the Investment Partnership constitutes "unrelated debt-financed income" taxable as UBTI. As a result, U.S. Tax-Exempts often invest in corporate Offshore Funds which act as "blocker corporations" to avoid attribution of the Fund's debt financing to the U.S. Tax-Exempts and thereby permit the U.S. Tax-Exempts to avoid the recognition of UBTI.

The Act includes a provision that would create an express exception to the debt-financed rules and permit U.S. Tax-Exempts to invest directly in Investment Partnerships without deriving any UBTI with respect to the income derived by the Investment Partnership through its use of borrowed funds in purchasing securities or commodities. The Act would not eliminate the possibility of a U.S. Tax-Exempt from deriving UBTI from an investment in an Investment Partnership, because certain investments, in particular investments in master limited partnerships ("MLPs) or other pass-through entities engaged in business activities, generate UBTI even if borrowed funds are not utilized.

The proposed legislation would apply to taxable years beginning after the date of the enactment of the Act.

If you have any questions regarding this Memorandum, please contact Dan Murphy (212-574-1210), Peter Pront (212-574-1221) or Jim Cofer (212-574-1688) of our Tax Group.

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