KIRKLAND**PEN**

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Private Equity Newsletter

Kirkland Partner Jack S. Levin Testifies to House Ways & Means Committee on Taxation of Private Equity, Venture Capital and Hedge Funds

PENpoints

"When Congress enacts laws [varying] ... the tax rates and rules ... by industry, the free market is inevitably distorted, with great risk of dire long-term consequences for American economic growth."

On September 6 the House Ways & Means Committee held a lengthy hearing on taxation of private equity, venture capital and hedge funds. A number of professors, economists and government witnesses strongly favored a change in the law to tax as ordinary income a carried interest in capital gain, while Kirkland partner Jack S. Levin, P.C. explained the reasons to continue long-term capital gain taxation of a general partner's carried interest in partnership-level long-term capital gain, giving rise to a spirited debate and a lengthy Q&A period.

The full text of Jack's testimony can be found at: http://www.kirkland.com/files/Levin_Testimony_090607.pdf. Excerpts from his testimony are set forth below:

Mr. Chairman and Committee members, my name is Jack Levin. ... In my brief testimony, ... I will try to answer 6 questions:

<u>First question</u>, why do we tax long-term capital gain ... at a lower rate than ordinary income, such as wages or interest income?

By imposing a lower tax on long-term capital gain than on ordinary income, Congress encourages the investment of risk capital in American business.... [and] the more risk capital invested into American business, the more our companies expand, create jobs and exports, and spread American prosperity.

* * *

<u>Second question</u>, when a partnership recognizes long-term capital gain, why is the portion flowing to a carried-interest holder taxed as long-term capital gain?

... The ... partnership flow-through tax approach [with partnership-level capital gain flowing through to the partners as capital gain] ... encourage[s] groups of people to join forces by combining their capital, labor and know-how to start, build and expand businesses [and] has contributed mightily to the vibrancy of America's entrepreneurial economy.

* * *

<u>Third question</u>, should carried interest partners be taxed at ordinary income rates on their share of the partnership's long-term capital gain because as joint venture managers they are really receiving sweat equity?

For many decades the Code has conferred the lower long-term capital gain rate on gain from the sale of a capital asset held more than 1 year, and throughout these decades the Code has never contained an absence-of-sweat test.

For example, assume Warren Buffett retires from Berkshire Hathaway and invests some of his money in stocks and real estate — working 8 hours at his desk every day, including Saturdays, to pick which stocks and real estate to buy, hold and sell — and assume we have a videotape of his activities showing that on many days he did indeed break a sweat while studying reports and placing buy and sell orders. Is (or should) his long-term capital gain on his stocks and real estate held more than 1 year be converted into ordinary income?

* * *

[I]f we [change the law to] tax carried interest capital gain differently than other capital gain, isn't ... the next step [to tax Warren Buffett at ordinary rates on his capital gain]? If venture capital, private equity and hedge fund managers who invest substantial capital and contribute substantial intangible assets in the form of (e.g.) know-how, reputation, goodwill, contacts and deal flow are to be tainted by sweat, shouldn't the same rule apply to Warren Buffett ...?

<u>Fourth question</u>, do Steve Schwartzman of Blackstone and his peers make so much money that they should be taxed more harshly?

* * *

Let's not repeat our past tax-legislation-by-vignette approach [, which brought us the odious and illogical AMT after a Congressional hearing discovered 21 unnamed American millionaires paid no federal income tax for 1967]. Just because some private equity investors ... make substantial amounts of money doesn't mean it is in America's best interests to impose tax penalties on them without carefully examining the macro-economic ramifications.

<u>Fifth question</u>, will changing the long-standing definition of capital gain to impose ordinary income tax on carried interests in long-term capital gain be harmful for the American economy?

Over the past 20 years or so, it has not been the big publicly traded auto companies and airlines that have provided growth in jobs, exports and prosperity. Rather it has been the venture capital, private equity and hedge fund financed companies that have made our economy the most efficient, vibrant and emulated in the world.

* * *

The basic principle of our free enterprise capitalistic economy is that American employment, growth and prosperity will be maximized by allowing the free market to operate.

It is the antithesis of the free market when Congress enacts tax laws targeting specific activities and designating winners and losers, for example, taxing carried interest in venture capital, private equity, real estate and hedge funds more harshly than other types of carried interest and more harshly than other investment gains. When Congress enacts laws [varying] ... the tax rates and rules ... by industry, the free market is inevitably distorted, with great risk of dire long-term consequences for American economic growth.

<u>Sixth question</u>, will a slowdown in venture capital/private equity investing hurt only fat cat venture capital/private equity professionals?

Among the largest investors in venture capital/private equity funds are pension plans and university endowments. Thus, a slow down in venture capital/private equity formation and investing harms not only new and growing American businesses that do not receive the funding necessary to start up, grow and prosper, but also the millions of American workers whose pension plans are the single largest venture capital/private equity investors and also the millions of American students whose tuition is reduced by their universities' endowment profits.

If you have any questions about the matters addressed in this Kirkland PEN article, please contact the following Kirkland author or your regular Kirkland contact.

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SEC Proposes Changes to Accredited Investor Definition and Certain Private Offerings Under Reg D

PENpoints

The newest proposals for Reg D private offerings expand the definition of accredited investor and create a new large accredited investor exemption.

In August 2007 the SEC proposed additional changes to its commonly used Reg D exemption from registration for a private placement of securities. These August 2007 proposed changes are in addition to the SEC's December 2006 proposal to narrow the accredited investor ("AI") definition for an individual participating in a Reg D offering by a "private fund."

The August 2007 proposals:

- expand the definition of AIs to add a new alternative "investments-owned" standard for individuals and entities;
- add a periodic inflation adjustment to the Reg D AI financial qualification standards beginning in 2012;
- create a new exemption allowing an operating company (but not a private fund) to engage in a limited amount of written advertising in selling securities solely to "large" accredited investors;
- shorten the non-integration safe harbor for Reg D offerings from 6 months to 3 months; and
- add "bad boy" disqualifying provisions to all Reg D offerings.

Proposed Additional AI Qualification

The August 2007 SEC proposal would permit an individual and an entity to qualify as an AI for an investment in an operating company (but not in most private funds[1]) if they own at least the following amount of investments:

- an entity could qualify as an AI with $5 million in investments, and
- an individual natural person could qualify as an AI with $750,000 in investments.

Existing rules generally define AI for an entity as at least $5 million in total assets and for an individual as at least $1 million net worth or at least $200,000 income (or $300,000 together with a spouse). The proposed new investments-owned standard would be an alternate test to the existing AI tests. All of the numerical AI tests would be adjusted for inflation beginning in 2012 (for inflation from 2007 thru 2011) and then every five years thereafter.

This proposed change is different than the SEC's December 2006 proposal to shrink the pool of AIs for private funds relying on the §3(c)(1) 100-investor rule for exemption from Investment Company Act of 1940 registration. Under the December 2006 proposal, an individual seeking to invest in such a private fund must qualify not only as an AI under the existing net worth or income tests, but also as an accredited natural person (an "ANP") by owning at least $2.5 million in investments.[2]

Proposed "Large" AI Exemption for Operating Company

The August 2007 SEC proposal would create a new category of exempt offering -- made solely to large accredited investors -- permitting the issuer to engage in limited written (including newspaper and internet, but not radio, TV, or other oral) advertising. This new exemption would be only for an operating company issuer, not a private fund.

The proposed new category of exempt offering would be limited to investors who qualify as "large" AIs. To qualify as a large AI:

- an entity would be required to have (1) $10 million in investments or (2) owners that are solely large AIs, and
- an individual would be required to either (1) own $2.5 million in investments or (2) have income of $400,000 (or $600,000 with a spouse).

In such an exempt offering, an unlimited amount of securities may be sold to an unlimited number of large AIs, with no sales to anyone not a large AI. The new large-AI exemption would also preempt state securities law (except for a possible notice filing requirement) allowing for a uniform national exemption like that available under current Rule 506.

An issuer could publish a written announcement of the offering (e.g., newspaper, magazine or online) including a 25-word limit on the description of the issuer's business, but an issuer would otherwise be subject to all restrictions on general solicitations. The SEC did not seek to limit how many times such written advertisements could be published or how long they could remain available online.

Integration Safe Harbor

Currently, Reg D offerings are not integrated with each other if conducted at least 6 months apart. Among other things, potential integration of Reg D offerings has limited the investments of non-AIs, since, under the specific Reg D exemption relied upon by most private funds, up to 35 non-AIs may participate in a particular offering (subject to certain information and financial sophistication requirements). The SEC proposal would shorten the integration period in Reg D offerings for all issuers from 6 months to 3 months.

"Bad Boy" Disqualification

The SEC also proposed new "bad boy" rules that could disqualify an issuer from making a Reg D private offering for between 5 and 10 years, if any of the issuer, its officers, directors, general partner or managing member, any beneficial owner of 20% of the issuer's equity securities and/or any promoter of the issuer is the subject of one of several types of serious adverse securities-related determinations, including criminal convictions in connection with a securities offering or determinations of violations of securities or related law by federal or state regulators.

Conclusion

Because the SEC explicitly requested comments (until October 9, 2007) on many aspects of the proposal, the SEC undoubtedly will receive many comments, and the final rule may be significantly different than the proposal as described above.

[1] Although the proposed additional investments-owned category for AIs technically applies to a Reg D offering by a private fund, in light of the much higher standards imposed by the SEC's December 2006 proposal for a §3(c)(1) fund and the existing qualified purchaser requirements for a §3(c)(7) fund under the Investment Company Act, the practical effect of this change on a private fund is likely to be minimal.

[2] For further discussion of the proposed ANP rule, please see (and click here for) the *Kirkland PEN* article titled "SEC Proposes Stricter Accredited Investor Test for Private Equity, Hedge and Certain Other Funds" from January 9, 2007.

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SEC Adopts New Antifraud Rule Affecting Communications and Conduct of Managers of Private Investment Funds

PENpoints

The new antifraud rule applies to deceptive communications and conduct of general partners and managers of private investment funds.

The SEC has adopted a new rule enhancing the SEC's right to take action against registered and unregistered investment advisers (including private equity and hedge fund general partners and management companies) who engage in deceptive communications or conduct directed toward investors, even if the conduct was negligent and not intentional.

A recent court decision had made it unclear whether the SEC could sue advisers under the existing antifraud rules of the Investment Advisers Act ("IAA") for statements and conduct directed toward investors in private funds and other pooled vehicles. The IAA's antifraud rules have always applied to registered and unregistered investment advisers, but the court decision had said that an adviser's client is the investment fund, and not the fund's investors. Accordingly, under the decision, conduct directed toward investors might not fall under the IAA's existing antifraud rules.

The new antifraud rule will apply to investors (including prospective investors) in any "pooled investment vehicle," which includes most private equity funds, hedge funds or other pooled investment vehicles.

Unlike certain other securities laws (e.g., Rule 10b-5), the new rule requires only that an adviser acted negligently (i.e., the conduct need not be knowing or deliberate), and the new antifraud rule applies whether or not the communication or conduct in question takes place in connection with the purchase or sale of a security. As discussed in the adopting release, the new rule would apply to communications and conduct such as:

- communications made or reports sent to investors or prospective investors (e.g., annual or periodic reports, pitch books or communications regarding the track record, experience and credentials of the adviser or its principals),
- a fund's valuation policies and procedures,
- the adviser's investment strategies for the fund and allocation or other operational policies for investments and
- disclosures regarding finders or solicitors used in fundraising.

While the new antifraud rule enhances and clarifies the SEC's enforcement authority to protect investors in pooled investment vehicles, the adopting release expressly states that it does not create an independent private right of action for investors against advisers for damages.

Given the new antifraud rule and its negligence-based standard, fund advisers, whether registered or unregistered, may want to review, enhance and formalize their communication practices and policies relating to the areas identified above.

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PENbriefs

Summary of Recent Legal and Tax Developments in Structuring Private Equity Transactions

Kirkland partner Jack S. Levin, P.C., has recently completed the latest update to his treatise, *Structuring Venture Capital, Private Equity and Entrepreneurial Transactions*. Jack has prepared a summary of recent legal and tax developments in the structuring of private equity transactions that are covered in the updated treatise. The summary is available at:

http://www.kirkland.com/files/2007_VC_Report_Letter.pdf

Are Broad Pre-Signing Market Checks Required? Recent Case Objects to Exclusion of Strategic Buyers in Limited Sale Process

A Delaware Chancery Court case found that a board of directors' and its special committee's decision to contact only potential private equity buyers and to not contact any potential strategic buyers prior to entering into a $115 million "going private" merger agreement was likely to be found unreasonable. Kirkland partners Stephen Fraidin and William B. Sorabella discuss this recent finding in an issue of *M&A Notes*, available at the following link:

http://www.kirkland.com/siteFiles/Publications/58A7AAD37F07D4406995B01D4A93BB8C.pdf

Topps Decision: Delaware Chancery Court Invalidates Standstill Agreement

In the recent case of *In re: The Topps Company Shareholders Litigation*, the Delaware Chancery Court held that the board of directors of The Topps Company most likely breached its fiduciary duties by misusing a standstill agreement with The Upper Deck Company. Kirkland partners Thomas Christopher and Jeffrey Symons discuss this ruling and its significance for M&A practitioners in an issue of *M&A Notes*, available at the following link:

http://www.kirkland.com/siteFiles/Publications/22C1032A78280A85E6AF2CDAD55C9B2A.pdf

PENnotes

The PLI Institute: Mergers & Acquisitions - What You Need to Know Now - 2007
Chicago, IL - September 27-28, 2007
San Francisco, CA - October 11-12, 2007

Kirkland partner R. Scott Falk, P.C., will co-chair these seminars, focusing on important developments and trends in M&A law in the year ahead. Kirkland partner Stephen Fraidin will speak at both events.

Kirkland's Biennial LBO/Private Equity Seminar
San Francisco, CA - October 5, 2007
New York, NY - October 12, 2007
Chicago, IL - October 19, 2007

Various Kirkland partners will present at this Kirkland seminar reviewing the legal, tax, structuring and practical negotiating aspects of complex private equity deals. For more information, contact Courtney Hudson at +1 (312) 649-3837 or chudson@kirkland.com.

The PLI Institute: Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings
Chicago, IL - October 10-12, 2007
New York, NY - October 24-26, 2007

This seminar will concentrate on the tax issues presented by modern major corporate transactions, from relatively simple acquisitions to multi-party joint ventures, complex acquisitions, and cross-border mergers. Kirkland partners Jack S. Levin, P.C., Donald E. Rocap, Todd F. Maynes, P.C. and Jeffrey T. Sheffield, P.C. will be featured speakers.

International Bar Association Annual Convention
Singapore - October 15, 2007

Kirkland partner David Patrick Eich will join the International Bar Association's private equity subcommittee as a panelist to discuss "Club Deals: Legal, Ethical and Practical Issues When Representing a Private Equity Consortium."

The 44th Annual Hawaii Tax Institute
Honolulu, HI - October 22-25, 2007

Kirkland partner Jack S. Levin, P.C., will speak on "Current Developments in Taxation of Corps, S Corps, Partnerships and LLCs."

Information Management Network's 8th Annual European Real Estate Opportunity & Private Fund Investing Forum
London, England - November 1-2, 2007

Kirkland partner Stephen G. Tomlinson, P.C., is speaking at this Kirkland-sponsored forum, which will feature discussions of strategies utilized by European funds and investors.

PLI's 39th Annual Institute on Securities Regulation
New York, NY - November 8-10, 2007

Kirkland partner Geoffrey W. Levin will participate in a panel discussion on private equity and hedge funds.

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Kirkland & Ellis LLP's Private Equity Practice

Kirkland & Ellis LLP's private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity and venture capital funds on behalf of more than 200 private equity firms in every major market around the world.

Kirkland has been widely recognized for its preeminent private equity practice. Awards in 2007 include first-tier rankings from Chambers & Partners for Private Equity Buyouts & VC Investment and from the International Financial Law Review in Private Equity Transactions. Chambers & Partners ranked Kirkland in 2006 as first overall in Private Equity Fund Formation, calling the group "one of the best in the world."

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