KIRKLAND & ELLIS LLP

KIRKLANDPEN
Private Equity Newsletter

December 11, 2009

Taxation of Carried Interest as Ordinary Income Passes House

PENpoints

The House-passed Tax Extenders Act of 2009 would tax as ordinary compensation income carried interest earned from investment partnerships or LLCs. This provision is similar to legislation passed by the House in 2007 and 2008 but rejected by the Senate.

On December 9, 2009, the House of Representatives passed H.R. 4213, the Tax Extenders Act of 2009 (the "Extenders Act"), which includes a provision taxing carried interest earned from investment partnerships or LLCs as compensation income subject to ordinary income tax and the uncapped Medicare tax (regardless of the nature of the partnership/LLC's underlying income). This carried interest provision is similar to legislation passed by the House in both 2007 and 2008, but rejected by the Senate on both occasions.

In light of the Senate's 2007 and 2008 rejection of similar carried interest proposals, prospects for Senate passage of this House proposal at this time are uncertain.

If enacted, the House's carried interest proposal would be effective for income recognized on or after January 1, 2010, regardless of when the investment partnership/LLC was formed or when the partnership/LLC made the underlying investment.

As passed, the House's carried interest provision applies only to investment professionals earning carried interest from an investment partnership/LLC, including a private equity, venture capital, hedge fund or real estate investment partnership/LLC. This is in contrast to the broader carried interest tax proposal in President Obama's Fiscal Year 2010 Budget (published February 2009), which proposed to tax carried interest earned from any partnership/LLC (including an operating partnership) as ordinary compensation income, but would not have been effective until January 1, 2011.

However, the Obama Administration has endorsed the Extenders Act's carried interest provision on the ground that it would "end the special preferential tax treatment for carried interest income."

INSIDE KIRKLANDPEN

In addition, the Extenders Act contains a provision intended to tax as a corporation (rather than as a flow-through entity) any publicly traded partnership/LLC (a "PTP") deriving significant income from investment advisory or asset management services. This legislation is aimed at structures similar to the Fortress and Blackstone IPOs, and is similar to a 2007 Senate bill discussed in a prior *KirkandPEN*.

Under current law, a PTP is generally taxed as a corporation unless at least 90 percent of its gross income consists of "qualifying income," generally interest, dividends, capital gains, real property rents and certain income related to minerals and natural resources. Under the Extenders Act (if enacted) any carried interest taxed as ordinary compensation income (as discussed above) will not constitute "qualifying income," so that any PTP deriving 10 percent or more of its gross income from such carried interest would be taxed as a corporation.

Unlike the carried interest provision discussed above, this PTP provision contains generous transition relief and thus would not apply to any existing PTP for 10 years.

The appendix to this *KirklandPEN* discusses the Extenders Act's carried interest provision in more detail.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

Jack S. Levin, P.C.
http://www.kirkland.com/jlevin
+1 312-862-2004

Donald E. Rocap
http://www.kirkland.com/drocap
+1 312-862-2266

William R. Welke, P.C.
http://www.kirkland.com/wwelke
+1 312-862-2143

Paul D. Patrow
http://www.kirkland.com/ppatrow
+1 312-862-2219

APPENDIX: More Detail on Extenders Act's Carried Interest Tax Provision

If enacted, the carried interest provision in the House Extenders Act would apply to carried interest allocated to any partner or LLC member who provides (directly or indirectly) a substantial quantity of any of the following types of services with respect to the assets held by such partnership/LLC:

"(A) Advising as to the advisability of investing in, purchasing, or selling any specified asset.

(B) Managing, acquiring, or disposing of any specified asset.

(C) Arranging financing with respect to acquiring specified assets.

(D) Any activity in support of [such services],"

and defines "specified asset" as (a) corporate stock, (b) interests in a partnership, (c) debt instruments, (d) notional principal contracts, (e) real estate held for rental or investment, (f) commodities, and (g) certain options, derivatives and other financial instruments with respect to assets described in (a) through (f).

The Extenders Act would tax as ordinary compensation income carried interest in a partnership/LLC allocable to a person providing such services to a partnership/LLC (regardless of the nature of the partnership/LLC's underlying income). Therefore, carried interest subject to this provision would be taxable at ordinary income rates and would also be subject to Social Security and uncapped Medicare taxes as self-employment income.

The Extenders Act would also treat as ordinary compensation income gain on the sale of a carried interest and appreciation in an asset distributed in kind to a carried interest holder, and would treat losses allocated to a carried interest holder as ordinary losses (up to the amount previously taxed as ordinary income under this provision).

The carried interest provision would not apply to allocations to a "capital interest" in a partnership/LLC, even if the capital interest is held by a service partner who also receives carried interest for providing investment services to the partnership/LLC (i.e., the carried interest provision does not apply to the extent a service partner's capital interest receives the same proportionate allocation of income and gains as capital interests held by investors not providing services). For this purpose, however, (1) a capital interest would not include a partnership/LLC interest purchased by a service partner with the proceeds of a loan (or other advance) made or guaranteed, directly or indirectly, by the partnership/LLC or by a partner not providing services to the partnership and (2) a non-service partner's loan to the partnership/LLC would be counted as non-service partner capital.

If enacted, the carried interest taxation provision would be effective January 1, 2010, regardless of when an investment partnership was formed or when underlying investments were made, so that gain from a partnership/LLC's sale of an asset or receipt of a dividend or other distribution on or after January 1, 2010, would be covered by the provision.

PENbriefs

Letters of Intent — Ties that Bind?

A recent decision by a Delaware court offers a timely reminder of the potential pitfalls for parties entering into letters of intent or term sheets with the expectation that they merely represent an unenforceable "agreement to agree." In that case, the court granted an injunction to a party to a letter of intent who alleged that its counterparty breached exclusivity and confidentiality provisions in the letter and failed to negotiate a deal in good faith. While the court's ruling is not novel and is consistent with prior decisions, it highlights the importance of parties being clear as to which provisions of a letter of intent or term sheet are intended to be binding and which are not. To learn more, please see our recent *M&A Update*, authored by Kirkland partner Daniel E. Wolf.

PENbriefs

District Court Limits the Right to Credit Bid in Asset Sale Conducted Under Chapter 11 Plan

As highlighted by the General Motors and Chrysler bankruptcy cases, companies experiencing financial distress may use the bankruptcy process to sell their assets "free and clear" of liens pursuant to section 363 of the Bankruptcy Code and pay the net sale proceeds over to their secured creditors. Section 363 also protects secured creditors whose collateral is being sold by enabling secured creditors to "credit bid" their claims at a section 363 sale to protect against a sale at what the creditors perceive is a below-market price.

Nonetheless, a recent decision by the District Court for the Eastern District of Pennsylvania held that debtors can preclude credit bids in asset sales conducted pursuant to a Chapter 11 plan (not pursuant to section 363), where secured creditors receive the "indubitable equivalent" of their claims. To learn more, please see our recent *Kirkland Alert*, authored by Kirkland partner David R. Seligman and associate Paul Wierbicki.

PENnotes

The Practising Law Institute's "Drafting Corporate Agreements 2010"
New York, New York - January 6, 2010
Chicago, Illinois - February 26, 2010

These PLI seminars will focus on drafting complete, concise and enforceable corporate agreements, and will discuss key terms of standard transactional agreements, when and how to use letters of intent, confidentiality and standstill agreements, and the wide range of M&A agreements, both public and private. Kirkland partner Andres Mena will speak on "Credit/Indenture Agreements" at the New York seminar and partner Gerald Nowak, a chair of the Chicago event, will present on "Introduction and Universal Issues in Drafting Corporate Agreements" in Chicago.

Columbia Business School's 16th Annual Private Equity and Venture Capital Conference
New York, New York
January 29, 2010

The 2010 Columbia Business School Private Equity and Venture Capital conference will focus on the future of the private equity industry and the role firms will play in a changing economic environment. Kirkland partner Kirk Radke will participate in a panel titled "The New World Order: Regulatory Practices and Private Equity Opportunities."

The 16th Annual Harvard Business School 2010 Venture Capital and Private Equity Conference
Boston, Massachusetts
February 13, 2010

The 16th Annual Harvard Business School 2010 Venture Capital & Private Equity Conference aims to address issues and trends relevant to venture capitalists, private equity investors, entrepreneurs and those who support the venture capital and private equity communities. Kirkland partners Kirk Radke and Andrew Wright are scheduled to speak at the conference.

The 2010 Private Equity and Venture Capital Conference at Northwestern University's Kellogg School of Management
Chicago, Illinois
February 10, 2010

The 2010 Kellogg School of Management's Private Equity and Venture Capital conference will provide a forum for discussing the opportunities and challenges that are currently reshaping the private equity and venture capital industries. Kirkland partner Sanford Perl will moderate a Portfolio Company Spotlight panel highlighting GTCR's ownership and sale of Ovation Pharmaceuticals.

Chicago
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
+1 (312) 862-2000
+1 (312) 862-2200 fax

Hong Kong
Kirkland & Ellis LLP
26th Floor
Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
+852-3761-3300
+852-3761-3301 fax

London
Kirkland & Ellis
International LLP
30 St Mary Axe
London, EC3A 8AF
United Kingdom
+44 20 7469 2000
+44 20 7469 2001 fax

Los Angeles
Kirkland & Ellis LLP
333 South Hope Street
29th Floor
Los Angeles, CA 90071
+1 (213) 680-8400
+1 (213) 680-8500 fax

Munich
Kirkland & Ellis
International LLP
Maximilianstrasse 11
80539 Munich
Germany
+49 89 2030 6000
+49 89 2030 6100 fax

New York
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
+1 (212) 446-4800
+1 (212) 446-4900 fax

Palo Alto
Kirkland & Ellis LLP
950 Page Mill Road
Palo Alto, CA 94304
+1 (650) 859-7000
+1 (650) 859-7500 fax

San Francisco
Kirkland & Ellis LLP
555 California Street
San Francisco, CA 94104
+1 (415) 439-1400
+1 (415) 439-1500 fax

Shanghai
11th Floor, HSBC Building
Shanghai IFC
8 Century Avenue
Pudong New District
Shanghai 200120
P.R. China
+8621 3857 6300
+8621 3857 6301 fax

Washington, D.C.
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
+1 (202) 879-5000
+1 (202) 879-5200 fax

Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. In 2009, Kirkland received the awards for Best Law Firm (Private Equity Deals) and Best Law Firm (Fund Formation) in North America from *Private Equity International*. Mergermarket has ranked Kirkland first by volume for Global and North American Buyouts in its "Global M&A Round-up for Year End 2008," and Pitchbook named Kirkland the most active law firm representing private equity firms in its "Private Equity Breakdown" for Q2 2009.

For the second year in a row, *The Lawyer* magazine recently recognized Kirkland as one of the "The Transatlantic Elite," noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent." In addition, Kirkland's London office was named the 2008 "Banking Team of the Year" at the Dow Jones Private Equity News Awards for Excellence in Advisory Services.

KIRKLANDPEN KIRKLAND & ELLIS LLP

EDITORS
Jack S. Levin, P.C.
Margaret A. Gibson, P.C.
Norbert B. Knapke II

SUBSCRIPTIONS
To subscribe to *KirklandPEN*, please e-mail
kirklandpen@kirkland.com