TREASURY DEPARTMENT PROVIDES DETAILS OF THE OBAMA ADMINISTRATION'S TAX CHANGE PROPOSALS AFFECTING CERTAIN INVESTMENT FUNDS AND THEIR MANAGERS

On May 4, 2009, the Obama Administration released a summary of its tax change proposals. On May 11, 2009, the Treasury Department issued the General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (the "Green Book") to provide details of the Administration's tax change proposals. The proposed changes summarized below, if enacted, would have adverse impacts on certain investment funds or their managers. These proposals generally would be effective after December 31, 2010.

- *Substitute Dividend Payments in Equity Swaps*. Investment funds often enter into equity swaps. These swaps usually provide substitute dividend payments to the funds. Under current law, while dividends paid to a foreign person by a domestic corporation generally are subject to a 30% withholding tax, dividend substitute payments to a foreign person on equity swaps are generally treated as foreign source income not subject to the withholding tax. Concerns of withholding avoidance have been raised for certain transactions, for example, where an offshore hedge fund sells stock before dividend payment but also enters into an equity swap and buys back the stock after the dividend payment. Senator Carl Levin recently proposed legislation to impose withholding tax on dividend substitute payments. The Obama Administration adopts a similar proposal, with a limited exception applicable if the equity swap does not require posting more than 20% of the value of the underlying stock as collateral, the underlying stock is publicly traded, no sale or buy-back takes place in connection with the swap transaction, and certain other requirements are met.

- *Substitute Payments in Securities Lending Transactions*. Under the Treasury regulations and guidance issued in 1997, substitute interest and dividend payments in a securities lending transaction or sale-repurchase transaction with respect to an instrument of a domestic issuer can be subject to withholding tax under certain circumstances. Concerns of withholding avoidance have been raised regarding situations where, for example, an offshore hedge fund lends the stock of a domestic corporation to a foreign financial institution in the same country which then sells the stock to, and enters into a total return swap with, a related U.S. person. The Green Book indicates that the Treasury Department will issue new guidance that would prevent avoidance of withholding tax through the use of securities lending transactions.

- *Carried Interest*. Under current law, service partners may be taxed at the capital gain rates, rather than the ordinary income tax rates, on their shares of partnership income and gain allocated to them pursuant to their carried interests in the partnership. This tax treatment has attracted extensive attention and publicity, and several bills have been introduced in recent years to change this result. The Obama Administration proposal would require a service partner to pay tax at ordinary income tax rates as well as self-employment tax on his share of partnership income and gain attributable to his carried interest. In addition, any gain recognized on the sale of the carried interest would also generally be taxed as ordinary income.

The Obama Administration's proposals described in the Green Book are far-reaching. It is difficult to predict what measures would eventually be enacted as proposed by the Administration.

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