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KIRKLANDPEN

KIRKLAND & ELLIS LLP

Private Equity Newsletter

New Tax Law Restricts Hedge Fund Fee Deferral Arrangements

PENpoints

Bailout bill taxes deferred compensation on a current basis from offshore entities not already subject to U.S. tax, principally targeting U.S. managers of offshore hedge funds.

The $700 billion "bailout bill" signed into law on October 3, 2008, contains changes to the U.S. tax code that will effectively eliminate the ability of U.S. hedge fund managers to defer paying tax on fee income from their offshore hedge funds.

As previously reported in the June issue of the Kirkland *Private Equity Newsletter*, over the past two years the U.S. Congress has considered several different pieces of legislation that would eliminate or significantly limit the ability of hedge fund managers to defer paying tax on compensation from offshore hedge funds. This new rule is projected to raise approximately $25 billion in tax revenue over 10 years.

Many hedge fund managers have put into place deferred compensation arrangements. Under the typical approach, the hedge fund manager elects to defer its receipt of performance fees and/or management fees otherwise due to it from the offshore hedge fund for a specified period of time, typically five to 10 years. During the deferral period, the fees are invested in the fund for the account of the manager. Prior to the enactment of this new law, the manager was not taxed until the compensation was ultimately paid and hence, assuming positive investment performance, the compensation could be invested and grow on a pre-tax basis.

The new law, enacted as part of the same bill that contained the Emergency Economic Stabilization Act of 2008, will impose U.S. tax on a current basis on deferred compensation from offshore entities that are not subject to U.S. tax or to a comprehensive non-U.S. income tax, with the principal target being U.S. managers of offshore hedge funds. Specifically, such compensation will be taxable at the time it "vests," that is, when the service provider's right to receive the compensation is no longer conditioned on his or her future performance of substantial services.

The new anti-deferral rule also applies to deferred compensation payable by a hedge fund or a private equity ("PE") fund formed as a domestic partnership, unless substantially all the income of such a partnership is allocated to taxable investors (including foreign investors subject to a comprehensive foreign income tax). However, most hedge funds and PE funds that are formed as partnerships provide incentives to fund managers by granting managers a carried interest in fund income that is considered an equity interest in the fund and thus should not be deferred compensation subject to the new anti-deferral rule.

The new law applies to compensation for services performed after December 31, 2008. Existing deferral arrangements attributable to services performed prior to December 31, 2008, are grandfathered under the new law, so long as the amounts deferred are taken into income no later than 2017. Under existing deferred compensation rules, elections to defer compensation for services performed in 2008 generally must have been made prior to 2008.

U.S. hedge fund managers should consider with their tax counsel the impact of this legislation on their hedge fund compensation arrangements as well as possible alternative approaches to structuring their compensation arrangements.

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

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PENnotes

The 8th Annual IVCA CFO Summit
Chicago, Illinois
October 16, 2008
This annual event, held at the University of Chicago's Gleacher Center, is offered for the benefit of venture capital and private equity firm CFOs and their staff. Topics covered will include: tax and accounting issues, fund formation structuring issues and non-cash compensation. Kirkland partner Bruce I. Ettelson, P.C., will discuss fund formation issues and updates.

PEI Infrastructure Investor Forum
New York, New York
October 22 - 23, 2008
This inaugural forum in New York will look at infrastructure from the perspectives of both fund managers and investors. Kirkland partners Bruce Gelman and Thomas Geraghty will lead a workshop focusing on "State of the Art Structuring for Infrastructure Funds and Investments."

KICP for Clients: The Fundamentals of Investing in Public Companies
Chicago, Illinois
October 28, 2008
Join Kirkland partners Christopher Butler, P.C., Keith S. Crow, P.C., Peter D. Doyle, R. Scott Falk, P.C., Robert M. Hayward, Marc Kieselstein, P.C., R. Henry Kleeman and Gerald T. Nowak at this Kirkland seminar, which will focus on the fundamentals of investing in public companies. Featured topics will include: "Investing through the Public Stock Markets," "Tactics of and Defenses Against Activist Shareholders" and "Alternative Investments in Public Companies." There is no charge for this seminar.

The Ninth Annual European Real Estate and Private Fund Investing Forum
London, England
October 29 - 30, 2008
This two-day seminar will focus on topics including: a macroeconomic overview, fund allocation and portfolio management strategies, the latest structures and debt financing available in today's market, U.S. residential distress and distressed opportunities in Europe. Kirkland partners Gary E. Axelrod and Jennifer M. Morgan will speak.

The Kellogg School of Management's 2008 Real Estate Conference
Evanston, Illinois
November 5, 2008
This year's conference will focus on a variety of relevant, action-oriented topics such as: the challenges and opportunities of operating in a volatile market, distressed strategies, executing deals in a changing global landscape and the multi-prong approach to true sustainable development. Kirkland is a sponsor of this event.

University of Chicago's Second Annual Real Estate Conference: Gridlock in the Capital Markets
Chicago, Illinois
November 10 - 11, 2008
This year's conference will feature prominent alumni from the university's Graduate School of Business and guest speakers discussing current issues effecting the commercial real estate industry. Kirkland partner Nathaniel M. Marrs will speak at this event.

Yale School of Management Private Equity Conference
Greenwich, Connecticut
November 14, 2008
This year's conference, "The Road Ahead," will focus on looking at longer term opportunities in sectors and regions that represent the next frontier of private equity investing. Specific topics will include: investment opportunities in clean technology and infrastructure, global sourcing and deployment of private capital, and the emerging operational imperative within private equity firms. Kirkland partners Stephen Fraidin and Kirk A. Radke will speak.

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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, venture capital and hedge 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. *The Lawyer* magazine recently recognized Kirkland as one of the firms in "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 2008, Mergermarket ranked Kirkland first by volume for Global and North American Buyouts in its "League Tables of Legal Advisers to Global M&A for Full Year 2007." Also in 2008, Kirkland received prestigious first-tier rankings in both private equity and fund formation from Chambers & Partners. Kirkland was named the "International Law Firm of the Year" in 2007 by *The Lawyer* magazine.

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