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KIRKLANDPEN
Private Equity Newsletter

March 22, 2010

House and Senate Enact Medicare Tax Increases

PENpoints

The healthcare and healthcare reconciliation bills increase Medicare taxes for high-income individuals, including a 3.8% Medicare tax on investment income.

On March 21, 2010, the House of Representatives passed the Senate healthcare bill (the "Senate Healthcare Bill") along with the healthcare reconciliation bill (the "Reconciliation Bill"), which bills will become law if (as is anticipated) the latter is passed by the Senate and both are signed by the President. Each bill contains a Medicare tax increase applicable to high-income individuals.

Medicare Tax Increase on Wages and Self-Employment Income

The Senate Healthcare Bill increases the current 2.9% Medicare tax by 0.9%—making the new Medicare tax rate 3.8%—applicable to an individual's wages and self-employment income in excess of $250,000 for a joint return (or $200,000 for other types of returns), effective for remuneration received after December 31, 2012.

The current 2.9% Medicare tax on remuneration is payable half by the employer and half by the employee, or 100% by a self-employed person. The new 0.9% Medicare tax is payable 100% by the employee or self-employed person.

Expansion of Medicare Tax to Individual Net Investment Income

The Reconciliation Bill expands the 3.8% Medicare tax to a high income individual's net investment income, effective for taxable years beginning after December 31, 2012. This new 3.8% tax will apply to the lesser of (1) an individual's net investment income and (2) the excess of the individual's adjusted gross income (AGI) over $250,000 (for a joint return) or $200,000 (for most other types of returns).

For example, if H and W file a joint return reporting $400,000 of AGI consisting of $250,000 in taxable wages and $150,000 in net investment income, the new 3.8% Medicare tax would apply to the full $150,000 of net investment income. However, if the H and W joint return reported $300,000 of AGI consisting of $150,000 in taxable wages and $150,000 in net investment income, the new 3.8% Medicare tax would apply to only $50,000 of net investment income.

INSIDE KIRKLANDPEN

The new 3.8% Medicare tax would apply to the following categories of investment income (net of allowed deductions allocable to such income):

- gross income from interest, dividends, annuities, royalties and rents (e.g., interest and dividends on bonds and stock),
- net gains (whether ordinary or capital) from disposition of property (e.g., gain from the sale of stocks, bonds and real estate, including a residence, to the extent included in taxable income), and
- other gross income derived from a business constituting a passive activity of the taxpayer (e.g., the taxpayer's share of a partnership or LLC business in which the taxpayer is not an active participant).

The new 3.8% Medicare tax does not, however, cover income from, or gain on the sale of, a business as to which the taxpayer is an active participant (i.e., is not a passive participant), nor does the tax cover distributions from tax-qualified retirement plans.

Although not wholly clear, it appears that the provision would not permit (i) a taxpayer who has an overall net loss from passive business activities to use such passive loss to offset income from interest, dividends, annuities, royalties and rents, or gains from asset dispositions, or (ii) a taxpayer with an overall net capital loss to use such loss to offset income from interest, dividends, annuities, royalties and rents, or non-capital gains from asset dispositions. However, as for regular income tax purposes, such losses appear to carry forward for purposes of calculating the 3.8% tax in subsequent years.

When effective, the new 3.8% tax would increase the top individual tax rate on (1) long-term capital gains and qualified dividends to 23.8% if, as proposed by the Obama Administration, the top rate on such gains and dividends increases to 20% (from the current 15%) as of January 1, 2011, and (2) interest income, non-qualified dividends and short-term capital gains to 43.4% if, as proposed by the Obama Administration, the ordinary income top rate increases to 39.6% (from the current 35%) as of January 1, 2011.

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New Legislation Expands U.S. Tax Withholding on Payments to Non-U.S. Persons

PENpoints

President Obama signed legislation last week designed to prevent U.S. citizens and residents from avoiding U.S. taxes by hiding ownership of U.S. assets in financial institutions located in tax-haven jurisdictions or safe-haven countries.

1. Background

The U.S. Treasury has recently fought highly publicized battles with non-U.S. financial institutions to prevent U.S. citizens and residents from avoiding U.S. taxes by hiding ownership of U.S. assets in non-U.S. institutions. These financial institutions are typically located in tax-haven jurisdictions (such as the Cayman Islands) or in safe-haven countries (such as Switzerland) whose bank secrecy laws prevent disclosure to third parties—including the IRS—of information regarding their account holders.

On March 18, 2010, President Obama signed legislation designed to combat these perceived abuses by requiring (1) 30% withholding on payments made to certain non-U.S. entities unless such entities agree to disclose information about their U.S. owners, and (2) disclosure by U.S. individuals of their ownership of foreign financial assets.

Private equity funds, hedge funds and funds of funds must consider changes to their fund agreements, subscription processes, and tax compliance to abide by the new rules with respect to (i) non-U.S. funds, (ii) non-U.S. alternative investment vehicles related to U.S. funds, and (iii) direct and indirect non-U.S. partners.

2. Two New Withholding Regimes

a. Regime 1: Payments to "Foreign Financial Institutions"

Under the first new withholding regime, any person (including an individual, corporation, partnership, or LLC) paying U.S. interest, dividends, royalties, or similar payments to a "foreign financial institution"[1] (e.g., to a Swiss bank or a non-U.S. investment partnership), will be required (beginning January 1, 2013) to withhold and pay over to the IRS 30% of the payments unless the foreign financial institution complies with disclosure and due diligence requirements.

Such withholding will also be required on gross sale proceeds—not merely gain—from disposition of any U.S. stock or U.S. debt, which amounts were previously generally exempt from U.S. withholding tax.

Thus, for example, once the new rules are effective (generally January 1, 2013), a private equity fund or other purchaser (or a broker if one is involved) will generally be required to withhold and pay over to the IRS 30% of the gross proceeds from the sale of U.S. stock or debt by a foreign financial institution (e.g., a non-U.S. fund or a non-U.S. alternative investment vehicle related to a U.S. fund), unless the foreign financial institution complies with due diligence and disclosure requirements.

A U.S. fund with a non-U.S. partner that is a "foreign financial institution" (e.g., a non-U.S. fund of funds that is an LP of a U.S. fund) will be required to withhold 30% of any U.S. interest, dividend, royalty or similar payment, as well as 30% of the gross proceeds from a sale of U.S. stock or debt allocable to such a non-U.S. partner, unless the partner complies with due diligence and disclosure requirements.

In most cases, these new rules are not intended to impose a new substantive tax; rather, amounts withheld will be credited against the beneficial owner's U.S. tax liability, if any. The beneficial owner will generally be able to obtain a refund of amounts withheld in excess of its U.S. tax liability by filing a U.S. income tax return or refund claim.

To avoid the 30% withholding tax, a foreign financial institution must enter into an agreement with the IRS requiring it to (i) make annual disclosures to the IRS about its U.S. account holders (including identifying direct and indirect U.S. beneficial owners) and the related accounts (including balances, deposits and withdrawals), (ii) undertake due diligence to determine direct and indirect U.S. beneficial owners, (iii) seek a waiver from each account holder of any non-U.S. law that would prevent reporting the required information and, if such a waiver is not obtained, close the account within a reasonable period of time, and (iv) withhold 30% of any distributions to account holders who do not supply required information.

b. Regime 2: Payments to Non-U.S. Entities That Are Not Financial Institutions

The second withholding regime applies the rules described above to payments to any non-U.S. entity that is not a foreign financial institution (e.g., to a non-U.S. corporation, partnership, or LLC not engaged principally in the business of investing, but not to an individual) unless the non-U.S. entity either (i) certifies that it has no "substantial United States owners" (defined generally as any U.S. person who owns directly or indirectly more than 10% of the entity by vote or by value) or (ii) provides the name, address and taxpayer identification number of each substantial United States owner.

Hence a fund with a non-U.S. entity partner that is not a foreign financial institution generally must withhold on U.S.-sourced distributions to such partner unless such partner provides the required certification or information.

3. Substantial Foreign Asset Disclosure Rules

The new legislation requires a U.S. individual owning foreign financial assets with an aggregate value of $50,000 or more to list (and disclose the value of) all foreign financial assets on his or her annual income tax return (beginning with calendar year 2011).

4. Dividend-Equivalent Payments

Under long-standing U.S. law, a U.S. corporation paying dividends to a non-U.S. person must withhold and pay over to the IRS 30% of the dividend (subject to reduction by an applicable tax treaty between the U.S. and the payee's foreign country). However, payments to non-U.S. persons on derivative contracts (such as equity swaps) calculated by reference to U.S. dividends have generally not been subject to this withholding tax (so long as the form of the transaction is respected for tax purposes). The new legislation changes this rule and treats such payments-in-lieu-of-dividends as U.S. dividends subject to the 30% dividend withholding tax for payments made after September 13, 2010.

1 A "financial institution" for these purposes is defined broadly to include banks, brokers, other financial intermediaries and investment vehicles, and thus appears to cover private equity funds, hedge funds and funds of funds. Such a financial institution is "foreign" if organized under non-U.S. law.

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The University of Chicago's 5th Annual Booth Distressed Investing and Restructuring Conference
Chicago, Illinois
April 16, 2010

The 5th Annual Chicago Booth Distressed Investing and Restructuring Conference, presented by the University of Chicago's Booth School of Business, will provide a broad overview of the state of the distressed investing and restructuring industry to professionals from around the country. Kirkland partner Jack S. Levin, P.C., will speak at this event and moderate a panel. Partners James H.M. Sprayregen, P.C., and Nicole L. Greenblatt will also participate as panelists.

The NYCBA's 7th Annual Institute on Tax Aspects of Mergers and Acquisitions
New York, New York
April 22, 2010

Kirkland partner Patrick C. Gallagher will speak on "Private Equity, Venture Capital and LBOs" at the New York City Bar Association's 7th Annual Institute on Tax Aspects of Mergers and Acquisitions.

The 30th Annual Ray Garrett Jr. Corporate and Securities Law Institute
Chicago, Illinois
April 29 - 30, 2010

The 30th Annual Ray Garrett Jr. Corporate and Securities Law Institute will take place from April 29 - April 30, 2010, in Chicago. More than 400 law firm and in-house attorneys will come together for a discussion of current issues including the capital markets today, financing and the return of the equity market, regulatory reform and the M&A market. Kirkland partner R. Scott Falk, P.C., will chair a session on "The Thawing of the M&A Market."

Infoline's Private Equity Regulation & Compliance Conference
London, UK
May 25, 2010

This Infoline conference will provide a practical update on regulatory and compliance developments for private equity firms. Kirkland partners Lisa Cawley and Stephanie Biggs will speak on "An Overview of U.S. Changes in Regulation Impacting Private Equity Firms."

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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. Kirkland received the 2009 and 2008 awards for Best Law Firm (Private Equity Deals) from *Private Equity International*. Mergermarket has ranked Kirkland first by volume for North American Buyouts and Exits in its "North American Private Equity in Review for 2009," and Pitchbook named Kirkland as one of the most active law firms representing private equity firms in its "Private Equity Breakdown" in 2009.

The Lawyer magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008 and 2009, 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."

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