

What to Expect in 2012: From Carried Interest Taxation to Chinese Antitrust Enforcement

The post-financial crisis, post-Dodd-Frank era has created challenging times for private equity. In this edition of the PEN, we look back at 2011 for clues for what private funds and their managers should expect in 2012.

U.S. Tax Outlook: Carried Interest Uncertainty; New Withholding Obligations

Carried Interest Uncertainty. Carried interest taxation remained a target in 2011, although Congress passed no legislation changing the long-standing flow-through treatment of carried interest income. President Obama's proposed American Jobs Act of 2011 would have (if passed) treated all of an investment professional's carried interest income earned from providing investment services to an investment partnership as ordinary income. ([See "Proposed Jobs Act Taxes 100% of Carried Interest as Ordinary Income", *KirklandPEN*, September 14, 2011.](#)) The Congressional super-committee was also reported to have discussed, but been unable to agree on, proposed carried interest legislation to present to Congress.

Looking forward, it seems likely that changes to the tax treatment of carried interest will be proposed again, either as a revenue raiser to pay for other budget items or as part of a broader tax-reform or budget-balancing effort. However, given current political divisions in Congress and the 2012 elections, enacting any such legislation in 2012 will likely be difficult. Whether carried interest legislation will be enacted in 2013 or later may well turn on the 2012 election results.

New Withholding Obligations. In an effort to make it more difficult for U.S. citizens and residents to avoid U.S. tax by hiding U.S. assets offshore, tax legislation enacted in 2010 (commonly called FATCA) imposes a 30 percent withholding tax on payments to certain non-U.S. entities unless those entities disclose to the IRS information about their direct or indirect U.S. account holders and owners. Payments of U.S. source interest, dividends and proceeds from the disposition of securities

producing such income made to a "foreign financial institution" (such as a private equity fund formed under non-U.S. law) will be subject to the FATCA withholding tax unless the foreign financial institution enters into and is in compliance with a withholding and disclosure agreement with the IRS (an FFI Agreement).

The IRS recently delayed the effective date of the FATCA withholding rules to apply to payments made after January 1, 2014 (in the case of dividends, interest and similar payments) and January 1, 2015 (in the case of principal and gross proceeds payments). Accordingly, the IRS announced that foreign financial institutions — including private funds and alternative investment vehicles formed outside the U.S. — will need to enter into an FFI Agreement by June 30, 2013 in order to meet these deadlines. We expect the IRS to issue proposed and final FATCA regulations and forms, as well as draft FFI Agreements, in 2012.

Both U.S. and non-U.S. funds should be aware that the FATCA rules may cause many non-U.S. investors to avoid investing in funds that invest in U.S. stocks and securities subject to potential withholding.

Fundraising

After a slow start in 2011, private equity fundraising ended the year with positive momentum. The market has bifurcated private equity firms: those with top returns that have addressed succession issues have been able to raise funds over a relatively short formal fundraising period, while those with below first-quartile returns or ongoing succession issues must lengthen their fundraising periods, reduce their fund size, offer economic incentives or make other concessions to attract investors. At the

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same time, potential investors continue to conduct increasingly more due diligence in advance of making a commitment. Orchestrating a sizeable first closing — the Holy Grail of fundraising — remains difficult for many firms.

The secondary market in private equity limited partnership interests remains robust, in part driven by the regulatory environment and increased tier one capital requirements for banks.

SBICs

In this challenging fundraising environment, private equity managers have shown increased interest in obtaining capital through the Small Business Investment Company (SBIC) program, which provides attractive loans to private equity firms licensed by the Small Business Administration (SBA) to finance small businesses. In addition to its general SBIC licensing program, in the spring of 2011 the SBA implemented the Impact Investment Initiative, an expedited licensing process committing up to \$1 billion in SBA-guaranteed financing over a five-year period to private equity funds targeting small businesses in areas of critical national priority. The SBA has also proposed implementing the Early Stage SBIC Initiative, which will commit up to \$1 billion in SBA-guaranteed financing over a five-year period to selected early-stage venture and seed private equity funds.

U.S. Regulation of Private Fund Managers

In 2011, most large private fund managers focused on preparing for SEC registration as investment advisers, with the SEC granting an extension for registration from the original Dodd-Frank date of mid-2011 until March 30, 2012. Many private fund managers used the extension to prepare their organizations to operate as regulated financial institutions with extensive new operational and disclosure requirements. In 2012, most private fund managers will become fully registered and subject to ongoing SEC oversight and examinations, requiring them to adopt a proactive and practical approach to the new and uncertain regulatory environment.

In addition to registration, beginning in late 2011, and continuing into 2012, private fund managers face several other new regulatory changes, such as:

- enhanced investor qualification standards and “bad

boy” disqualifiers for private offerings;

- expansion of state lobbying laws to cover fund personnel;
- restrictions on political contributions; and
- systemic risk, large trader and other reporting obligations.

On a positive note, several bills are pending in Congress that could benefit private fund managers, including increasing the number of investors a private company such as a fund may have (currently less than 500) before it must file periodic public reports with the SEC, and potentially allowing more public statements about private fund offerings without violating Regulation D’s ban on general advertising.

The View from Europe

Private Fund Regulation. Notwithstanding the turmoil in the Eurozone, several major EU regulatory initiatives continue to move forward. The EU Alternative Investment Fund Managers Directive (AIFMD), which regulates private equity firms undertaking fund management activities within the EU and/or marketing fund interests to EU-based investors, will take effect on July 22, 2013. The framework for the new regime is already settled, but the details should become clearer as both national governments and the European Commission seek public comment on proposed implementing legislation during 2012. The coming year should also bring more details of the EU’s recent proposal to create a pan-European marketing regime for venture capital firms falling below the AIFMD’s €500 million qualification threshold for registration. Full implementation of the “Solvency II” reforms, which will increase the regulatory capital “cost” of private equity investments for EU insurers, now looks likely to be delayed until January 2014. However, we expect larger EU insurers to move towards Solvency II compliance in advance of this deadline.

German Bankruptcy Law Reform. On March 1, 2012, a comprehensive insolvency reform law will go into effect in Germany that will significantly improve the ability of a private equity firm to preserve value in the event a German portfolio company must seek bankruptcy protection. Current German restructuring laws have proven inadequate in practice and are rarely used to implement strategic restructuring measures. The new law brings German restructuring practice closer to the U.S.

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Chapter 11 model and establishes a value-maximizing, in-court alternative for a distressed portfolio company by, among other things, (1) reducing the influence of insolvency trustees, (2) reinforcing the debtor-in-possession concept, (3) establishing creditor commitments earlier in the process and (4) facilitating debt-for-equity swaps.

Antitrust Trends in the United States, China and India

HSR Filings. Amendments to the Hart-Scott-Rodino Antitrust Improvements Act (HSR Act) premerger notification rules and report form became effective in August 2011. As predicted in an earlier *KirklandPEN* ([“FTC/DOJ Announce Changes to HSR Rules and Notification Form”, July, 13, 2011](#)), the new rules increased the burden on private equity funds with respect to the time, effort, and expense necessary to gather and analyze the additional information and documents that the form now requires. Much of the additional burden on private funds relates specifically to the analysis and identification of “associated” entities under common investment-decision management with the filing fund. The FTC Premerger Notification Office recently has provided additional, helpful guidance on “associated” entities and other requirements in the new rules.

U.S. Antitrust Enforcement. We expect the recent trend by the U.S. Department of Justice (DOJ) and (FTC) of aggressive examination of all competitor transactions, even those with only modest overlaps, to continue in 2012, as well as increased and earlier agency political appointee involvement in such deals.

The intensity of agency scrutiny during the initial HSR Act waiting period and any second-request phase has

increased, lengthening clearance timelines and adding to pre-closing deal expenses.

In particular, the DOJ’s successful 2011 merger challenges (H&R Block/TaxACT, AT&T/T-Mobile) may embolden it to take a tougher stance in high-profile, high-overlap competitor transactions in 2012. It is unlikely, however, that the DOJ’s successes in these high-profile cases will impact transactions where there are no or only modest overlaps, or overlap deals that can be easily remedied through divestitures.

In 2012, we expect the FTC to continue its modestly aggressive enforcement approach, with a continued sharp focus on health care, pharmaceuticals and Internet/high tech, and to continue to look for HSR compliance violations.

China and India. Antitrust regulators in China and India grew more assertive and independent in 2011, as regulators in these countries have substantially overhauled and expanded their merger review regimes, resulting in potentially lengthy review periods. Recently, China has required remedies (such as an increase in production and R&D spending post-merger) in a transaction cleared by both the FTC and the European Commission.

Chinese buyers have faced continued opposition to certain attempted investments in Western countries. Three recent antitrust decisions by the European Commission regarding mergers involving Chinese state-owned enterprises (SOEs) show that the European authorities are questioning whether the SOEs, among the most active Chinese M&A market participants, are sufficiently independent of the Chinese state, with implications for both determining jurisdiction and substantive antitrust review.

PENnotes

2012 PLI's Real Estate M&A and REIT Transactions
New York, New York – Live via Webcast
January 12, 2012

Kirkland & Ellis partner Edward Schneidman will participate in PLI's Real Estate M&A and REIT Transactions 2012, scheduled for January 12, 2012 in New York and via live webcast. The program will take an in-depth look at some of the transactions completed in 2011, and will explore the structures, legal frameworks and dynamics of the current environment, including strategies for restructuring real estate portfolios and companies in and out of bankruptcy; for successfully identifying and executing transactions; and for raising new capital, through equity offerings and other means. [Click here](#) for more information about the New York event or for information about the live webcast.

American Securitization Forum 2012
Las Vegas, Nevada
January 22-25, 2012

Kirkland & Ellis is an associate sponsor of ASF 2012, which attracts the securitization industry's top professionals. In addition, Kirkland & Ellis partner, Kenneth Morrison, is scheduled to present on a panel discussing the "FDIC Role in Structured Finance Transactions." ASF 2012 will build on the success of last year's conference, with more than 4,500 participants expected. Conference attendees will participate in sessions on relevant industry topics presented by the top industry executives. [Click here](#) for more information or to register for this event.

The 18th Annual Columbia Business School Private Equity and Venture Capital Conference
New York, New York
February 3, 2012

Kirkland & Ellis is a sponsor of the Columbia Business School Private Equity and Venture Capital Conference, which will bring together alumni, professionals and students for informative discussions on recent opportunities and challenges that have emerged in the private equity and venture capital industries. Kirkland & Ellis partner, Kirk Radke, will be a member on a panel entitled "The Leveraged Buyout" during the conference. [Click here](#) for more information or to register for this event.

Kellogg Private Equity Venture Capital Conference, Finding Growth in the Next Generation
Chicago, Illinois
February 15, 2012

Kirkland & Ellis is a sponsor of the Kellogg School of Management's 13th Private Equity and Venture Capital Conference, "Finding Growth in the Next Generation." The conference brings together some of the biggest names and brightest minds in the fields of private equity and venture capital to discuss the opportunities and challenges facing the industry. This year's conference will provide a forum for private equity investors, venture capitalists, entrepreneurs, and LPs to discuss how the next generation of funds will find growth and ultimately drive returns for investors. Attendees will have the opportunity to gain insights, pose questions and network with leading investment professionals representing a diverse group of firms, markets and geographies. More information to come.

18th Annual Harvard Business School Venture Capital and Private Equity Conference
Boston, Massachusetts
February 17-18, 2012

A trio of Kirkland partners will participate in various panel discussions at the 18th Annual HBS Venture Capital and Private Equity Conference. Anup Sathy will contribute to the panel topic entitled "Distressed and Special Situations," Kirk Radke will speak on the panel regarding "Large Cap Private Equity: A Return to Normalcy?" and Karyn Koiffman will participate on the topic "Private Equity Investing in Latin America." Kirkland is a sponsor of the event. [Click here](#) for more information.

The 11th Annual University of Chicago Private Equity Conference, Expanding Private Equity Beyond Traditional Models
Chicago, Illinois
February 24, 2012

The University of Chicago hosts its 11th annual Private Equity Conference. This year's theme is "Expanding Private Equity beyond Traditional Models." The event, hosted in part by Kirkland & Ellis, aims to provide high value to private equity practitioners by combining knowledge from both the industry and academia.

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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. The Firm was named Best M&A Firm in the United States at World Finance's 2011 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 IFLR Americas Awards. Kirkland was also recognized as "Law Firm of the Year" for Private Equity by *U.S. News & World Report* "Best Lawyers" 2011-2012 and "Law Firm of the Year" in *Buyouts* magazine's "2010 Deal of the Year Yearbook." Kirkland was ranked in the first tier among law firms for both Private Equity Buyouts and Private Equity Funds by *The Legal 500 U.S. 2010*. Additionally, *Pitchbook* named Kirkland as one of the most active law firms representing private equity firms in its 2010 "Private Equity Breakdown."

The Lawyer magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008, 2009 and 2010, 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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