SEWARD & KISSEL LLP

October 28, 2004

MEMORANDUM TO CLIENTS

NEW TAX LAW CHANGES RELATING TO FEE DEFERRAL ARRANGEMENTS

Attached is our memorandum entitled "Effect of New Tax Law on Fee Deferral Arrangements of Investment Fund Managers" which discusses the impact of the American Jobs Creation Act of 2004 (the "Act") on the typical deferral arrangements hedge fund managers have entered into regarding the management and/or incentive fees they receive from offshore funds.

The key points of the Act as they relate to hedge fund deferral arrangements are as follows:

1. Deferral arrangements are still permitted after 2004; however, the terms of existing arrangements will likely be required to be amended to comply with the Act.

2. Deferral arrangements for pre-2005 periods are not affected by the Act unless amendments are made to the terms of pre-2005 arrangements that are deemed to result in a "material modification" of the arrangements.

3. Pending further Treasury Department guidance, "back-to-back" deferral arrangements (i.e., where all or a portion of a manager's fee deferrals are accelerated upon an employee or member of the manager ceasing to work with the manager) may not be permitted for post-2004 deferrals.

4. Re-deferrals or extensions of deferrals are permitted in certain circumstances if specified requirements are satisfied.

5. Offshore "rabbi trusts" are no longer permitted.

6. Subject to further Treasury Department guidance, deferred amounts may be reportable to the Internal Revenue Service on a current basis even though they are not taxed until a later period.

While we are awaiting further guidance from the Treasury Department that the Act requires to be issued prior to year-end, clients should begin to review with us their existing deferral arrangements to ensure compliance with the Act. In this regard, you should contact Peter Pront or Dan Murphy of our Tax group or the partner in our Investment Management Group who handles your account.

Seward & Kissel LLP

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MEMORANDUM

EFFECT OF NEW TAX LAW ON FEE DEFERRAL ARRANGEMENTS OF INVESTMENT FUND MANAGERS

I. Introduction

The American Jobs Creation Act of 2004 (the "Act"), which was signed into law on October 22, 2004, contains provisions significantly affecting the taxation of nonqualified deferred compensation plans, agreements and similar arrangements (collectively, "Deferred Compensation Plans"). In addition to applying to the typical deferred compensation arrangements involving individual employees and independent contractors, these new provisions also apply to the arrangements entered into by U.S.-based managers ("Fund Managers") of offshore investment funds ("Offshore Funds") to defer their receipt of the management fees and/or incentive fees payable to them by the Offshore Funds (collectively, the "Fees"). This memorandum sets forth our preliminary analysis of the significant provisions of the Act that may affect the Deferred Compensation Plans of Fund Managers.

As an initial matter, we note that the Act generally does not apply to deferral arrangements relating to Fees earned prior to December 31, 2004. In addition, the Act permits Fund Managers to continue to defer the receipt and taxation of Fees earned after December 31, 2004, provided that their Deferred Compensation Plans are structured to comply with the Act's provisions. However, as discussed more fully below, Fund Managers will have to review the terms of their existing Deferred Compensation Plans to determine whether any amendments need to be made thereto in order to comply with the new provisions contained in the Act.

The Act grants the Treasury Department discretion to issue interpretive guidance with respect to certain of the provisions relating to Deferred Compensation Plans and it is possible that such future guidance could prospectively restrict or eliminate the deferral opportunities available to Fund Managers. As discussed more fully below, in many cases we recommend that any necessary amendments to a Fund Manager's Deferred Compensation Plan be postponed until such guidance is issued. We will provide a more detailed analysis of the Act after the Treasury Department issues such guidance.

Among other provisions, the Act imposes certain requirements regarding deferral elections, permissible distributions and accelerations of payment from Deferred Compensation Plans. Unless all of these requirements are satisfied by a particular Deferred Compensation Plan, (i) the compensation subject to a deferral election under the Plan will be taxable to the service provider in the taxable year in which the services were rendered, (ii) interest at the tax underpayment rate plus one percentage point will be imposed on any underpayments attributable to the failure of the service provider to pay tax currently on the compensation, and (iii) the taxable compensation will be subject to a 20 percent additional tax.

II. Key Provisions of the Act

A. Effective Date

The Act generally is effective for amounts deferred in taxable years beginning after December 31, 2004. Deferral elections made by Fund Managers with respect to Fees relating to services performed on or after January 1, 2005 will be required to comply with the Act in order to be effective. The Act therefore generally does not apply to deferral elections made with respect to taxable years which end prior to 2005. However, Fees deferred in such pre-2005 taxable years will be subject to the Act if the provisions of the applicable Deferred Compensation Plan relating to such pre-2005 deferrals are materially modified after October 3, 2004. Subject to future Treasury Department guidance, it currently is not clear whether the Act will apply to a deferral election made during 2004 by a Fund Manager of an Offshore Fund that has a fiscal year beginning in 2004 and ending in 2005.

The Act specifically treats earnings on deferred compensation as additional deferred compensation for purposes of the Act. Therefore, it appears that the Act generally should not have any application to the earnings attributable to pre-2005 deferrals.

The Act mandates that within the 60-day period following the enactment of the Act (i.e., by December 22, 2004), the Treasury Department will issue guidance on the deferred compensation provisions which will provide a "limited period of time" during which a Deferred Compensation Plan adopted before 2005 may, without resulting in a "material modification" to the terms of the Deferred Compensation Plan, be amended (i) to permit a participant to terminate its participation in the Deferred Compensation Plan, or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, or (ii) to conform with the Act relating to amounts deferred after 2004. Therefore, given the significant penalties (i.e., imposition of a 20 percent additional tax) that would be imposed on a Deferred Compensation Plan that fails to satisfy the provisions contained in the Act, we recommend that no significant amendments be made to the existing Deferred Compensation Plans of Fund Managers until the Treasury Department guidance has been issued.

B. Distribution Events

The Act restricts the type of events that may accelerate the payment of deferred compensation under a Deferred Compensation Plan.[1] For example, the Act does not permit the

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[1] The Act provides that compensation deferred under a Deferred Compensation Plan may be distributed no earlier than (1) separation from service (as determined by applicable Treasury Department guidance), (2) serious disability likely to result in death or expected to last for 12 consecutive months, (3) death, (4) a specified time (or pursuant to a fixed schedule) specified under the Deferred Compensation Plan at the time the deferral election is made, (5) a change of ownership of the employer, or (6) the occurrence of an "unforeseeable emergency" provided that the distribution is limited to the amount necessary to satisfy the emergency.

acceleration of payments upon the happening of a specified event or under circumstances where a substantial penalty (a "haircut") is imposed on the recipient as consideration for such acceleration. Therefore, provisions in Deferred Compensation Plans permitting the acceleration of payments upon a "change in tax law" that would cause a Fund Manager to be taxable on all or a portion of the compensation previously deferred may not be permitted. We recommend that Fund Managers review their Deferred Compensation Plans to determine whether any modifications need to be made to the applicable distribution provisions.

As set forth in footnote 1, the Act provides that a "separation from service" (as determined by applicable Treasury Department guidance) is a permissible event for the distribution of payments under a Deferred Compensation Plan. We believe that the termination of the Investment Management Agreement between a Fund Manager and an Offshore Fund generally should constitute a "separation from service" within the meaning of the Act. However, depending on the forthcoming Treasury Department guidance, it is possible that a "separation from service" may not be deemed to occur if the Investment Management Agreement is terminated in connection with the transfer by a Fund Manager of the investment management functions with respect to an Offshore Fund to an affiliate of the Fund Manager.

Based on the literal language of the Act and subject to any clarification in future Treasury Department guidance, it appears that the Act may not permit "back-to-back" deferral arrangements pursuant to which a Fund Manager's deferral election mirrors a deferral election made by employees or equity owners of the Fund Manager and permits a distribution to the Fund Manager upon the employee or equity owner's ceasing to provide services to the Fund Manager.[2]

Because the termination of the electing employee or equity owner does not involve a "separation from service" of the Fund Manager from the Offshore Fund, it is not clear under the Act whether an early distribution of the sub-account maintained by the Offshore Fund with respect to the terminating employee or equity owner is a permissible distribution under the Fund Manager's deferral arrangements with the Offshore Fund. Unless the Treasury Department's future interpretive guidance clarifies this issue, we recommend that Fund Managers that currently utilize such "back-to-back" deferral arrangements should cease utilizing such arrangements. We note, however, that nothing in the Act prohibits the deferral election made by a Fund Manager from reflecting the individual deferral elections made by its employees and/or equity owners. However, subject to clarification by Treasury guidelines, the Fund Manager's deferral election should not provide that distributions from the Offshore Fund are triggered upon the termination of service of any of these individuals.

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[2] The existing deferral elections of some Fund Managers expressly provide for the creation of sub-accounts by the Offshore Fund for each individual employee or equity owner of the Fund Manager that makes a deferral election with the Fund Manager. If the electing employee or equity owner terminates his service with the Fund Manager for any reason prior to the deferral date specified by the Fund Manager in its deferral election, the Offshore Fund will distribute to the Fund Manager the deferred compensation attributable to the terminated employee or equity owner. Such an early distribution does not affect the deferral attributable to the remaining employees or equity owners.

C. Timing of Deferral Elections

The Act provides specific limitations regarding the timing of deferral elections. While these limitations generally reflect current practice,[3] the Act provides a special election timing rule with respect to "performance-based compensation" that is more favorable than existing law. The Act provides that where "performance-based compensation" is earned for services performed over at least a 12-month period, the deferral election relating to such compensation may be made no later than six months before the end of the performance period. While at first glance it appears that a Fund Manager that is entitled to receive an "incentive fee" based on the annual investment performance of the Offshore Fund may be entitled to rely upon this special extended election period, this extended period may be unavailable to Fund Managers who are entitled to receive an incentive fee at the time an investor redeems its interest in the Offshore Fund during a particular year (since the measurement of the incentive fee in this situation would not be based on a period of at least 12 months). Therefore, until the Treasury Department provides further interpretive guidance on this provision, we recommend that Fund Managers continue to make their deferral elections with respect to all of their Fees prior to the year in which the services are to be rendered.

D. Re-deferrals

Under current law, it is unclear whether a Fund Manager who has elected to defer its Fees for a specified period can elect before the end of such period to extend the deferral period without subjecting the deferred Fees to current taxation. The Act expressly permits a Deferred Compensation Plan to allow a re-deferral if (i) the re-deferral election is made at least 12 months prior to the end of the deferral period specified in the prior deferral election, and (ii) except in the case of elections relating to death, disability or unforeseeable emergency, the Deferred Compensation Plan requires that the additional deferral be for a period of an additional five years from the expiration of the original deferral period.

We note that the Act does not specifically address the number of re-deferrals that can be made under the new rules described above. This is an issue which may be addressed in the forthcoming Treasury Department guidance and on which we will provide further guidance at a later time.

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[3] Except as provided by future Treasury Regulations, the Act requires a Plan to provide that deferral elections must be made no later than the close of the taxable year that precedes the taxable year in which the services are rendered. For the first taxable year in which the Fund Manager is eligible to defer its Fees under its Deferred Compensation Plan, the deferral election must be made within 30 days after the commencement of the Investment Management Agreement with the Offshore Fund. Presumably, the Treasury Department will issue guidance addressing the timing of deferral elections in situations where the Offshore Fund has a fiscal year other than December 31.

Prior to the Act, some Fund Managers that receive Fees on a quarterly basis made deferral elections with respect to such Fees on or before the beginning of the quarter during which the Fees were to be earned. However, the Act requires such Fund Managers to make their deferral elections with respect to their quarterly Fees at the beginning of the year involved.

The Act appears to require that re-deferrals must specifically be permitted by the terms of the Deferred Compensation Plan. Therefore, after the Treasury Department issues its interpretive guidance on the Act, we recommend that the Deferred Compensation Plans of Fund Managers which do not currently address re-deferrals should be amended to expressly permit such re-deferrals with respect to taxable years beginning after 2004. Subject to such guidance, it is not currently clear whether a Fund Manager will be entitled to re-defer amounts previously deferred prior to 2005.

E. Offshore Funding

The Act generally provides for the current taxation of any compensation subject to a deferral election if assets are located or transferred outside of the United States are "set aside in a trust (or other arrangement determined by the [Treasury Department]." This rule does not, however, apply to assets located outside the United States if substantially all of the services to which the deferred compensation relates are performed in the jurisdiction where the assets are held.

Based on the legislative history of the Act, it appears that this provision was intended to specifically apply to "offshore rabbi trusts" and similar arrangements where an employer "sets aside" or segregates a portion of its assets pursuant to a specific arrangement. Subject to further analysis after the issuance of future Treasury guidance in this issue,[4] we believe that this special taxation rule should not apply where an Offshore Fund holds all or a portion of its assets with a foreign prime broker for valid business reasons and does not segregate any of such assets in a separate arrangement for the benefit of the Fund Manager.

F. Permissible Investments

The Act does not contain any provision restricting the types of investments that can be utilized by a Fund Manager as a measurement of the earnings attributable to compensation deferred under a Deferred Compensation Plan.[5] Therefore, Fund Managers can continue to have their Fee deferrals invested in shares of the Offshore Fund or, to the extent permitted by the applicable Deferred Compensation Plan, in other investments agreed upon by the Fund Manager and the Board of Directors of the Offshore Fund.

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[4] The Act expressly authorizes the Treasury Department to issue regulations exempting from the Act arrangements that will not result in an "improper deferral" of United States taxes and will not result in assets being effectively beyond the reach of an employer's creditors.

[5] We note that an earlier proposed version of the Act that would have restricted the types of investment options that could be utilized under a Deferred Compensation Plan to either (i) investment options that are comparable to those that may be elected by participants in the qualified retirement plan maintained by the employer that has the fewest investment options, or (ii) if the employer did not maintain any qualified retirement plan, investment options to be specified in guidance issued by the Treasury Department.

G. New Reporting Provisions

The Act imposes new reporting and federal income tax withholding requirements with respect to amounts required to be included in income under the Act. The Act requires annual reporting to the Internal Revenue Service of "amounts deferred" under Deferred Compensation Plans.[6] Such amounts are required to be reported on a service provider's IRS Form W-2 or Form 1099 for the year deferred even if the amount is not currently taxable in that taxable year. It is not clear from the Act whether the "deferred" amounts subject to such reporting includes current or prior "earnings" on the deferred compensation. We expect that future Treasury Department guidance is likely to clarify this issue.

The Act's new reporting requirements clearly would apply to any compensation deferred by employees of a Fund Manager. In order to avoid being subject to the Act's new reporting requirements and an increased risk of having their Deferred Compensation Plans scrutinized by the Internal Revenue Service, Fund Managers may wish to consider the extent to which their employees should be permitted to defer their shares of the Fees derived by the Fund Managers.

Because the Act's focus is on deferred compensation arrangements entered into by individuals, rather than entities, the Act does not specifically address the extent, if any, to which the new reporting rules are applicable to the deferred compensation of entities treated as partnerships (including limited liability companies) and their partners (or members) who receive a Schedule K-1 from the partnership, rather than a Form W-2 or Form 1099. We expect that future Treasury Department guidance should address this issue.

If you have any questions regarding this Memorandum, please contact Daniel Murphy (212-574-1210) or Peter Pront (212-574-1221) of our Tax Group or the partner in our Investment Management Group who handles your account.

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[6] The legislative history of the Act reflects Congressional expectation that this annual reporting of deferred amounts will provide the Internal Revenue Service with greater information regarding such arrangements so as to provide an indication of what arrangements should be examined and challenged.