October 11, 2005

INVESTMENT FUNDS ALERT

UPDATE ON LEGISLATION RELATING TO NONQUALIFIED DEFERRED COMPENSATION PLANS FOR HEDGE FUND MANAGERS

The American Jobs Creation Act of 2004 (the Act), which includes new rules and restrictions with respect to nonqualified deferred compensation plans, was signed into law on October 22, 2004. The rules and restrictions generally apply to existing plans only with respect to amounts "earned and vested" after December 31, 2004. On December 20, 2004, the Treasury Department and the Internal Revenue Service issued Notice 2005-1 (the December Notice), which provided interim guidance with respect to the Act as it relates to nonqualified deferred compensation plans. (*See* Investment Funds Alert, dated October 15, 2004 (http://www.akingump.com/docs/publication/700.pdf) and Investment Funds Alert, dated December 2004 (http://www.akingump.com/docs/publication/718.pdf).)

On September 29, 2005, the Treasury Department and Internal Revenue Service issued a Proposed Regulation (the Proposed Regulation) under Section 409A of the Internal Revenue Code of 1986, as amended (the Code), which generally becomes effective as of January 1, 2007 (http://www.treas.gov/press/releases/reports/reg15808004.pdf). The Proposed Regulation implements much of the guidance contained in the December Notice, with certain notable modifications, clarifications and additions.

Set forth below is a brief Q&A relating to the Proposed Regulation that addresses issues which may be of interest to fund managers.

Q: **Does the Act apply to fund managers?**

A: Yes. The December Notice provides a general exemption from application of the Act to service providers that have multiple unrelated clients (see Q&A #8 of the December Notice). However, it was unclear under the December Notice whether the Act applies to most hedge fund managers who have multiple unrelated clients. The Proposed Regulation clearly provides that when the service recipient (e.g., a fund) is purchasing an independent contractor's management services (e.g., an investment manager), amounts deferred should not be excluded from coverage under the Act because the fund is not unrelated to the investment manager for purposes of this exception.

Q: **Does the Proposed Regulation clarify how the Act applies to entities that are taxed as partnerships?**

A: No. The Proposed Regulation reserves on this issue.

Q: **Does the Proposed Regulation address "back-to-back arrangements"?**

A: Yes. In general, an arrangement between a service recipient (e.g., a fund) and a service provider (e.g., an investment manager), where the service provider is also a service recipient vis-à-vis its employees, may provide for the payment to the investment manager upon the occurrence of a payment event relating to (i) separation from service, (ii) disability, (iii) death, (iv) change in ownership or (v) unforeseeable emergency, where the time and form of payment are defined as the same time and form of payment provided under an arrangement subject to the Act between the investment manager and its employees, if the arrangement between the fund and the investment manager expressly so provides. The permissibility of this type of back-to-back arrangement was unclear under the December Notice. Although this general rule should be beneficial for fund managers with back-to-back arrangements with their employees, it is unclear to what extent it applies with respect to payments to retiring partners of the investment manager (i.e., it is unclear whether deferred compensation amounts due to a partner can be accelerated based on separation from service, disability, death or an unforeseeable emergency of the partner or as a result of a change of ownership of the partnership).

Q: **When does an initial election need to be made for a new fund?**

A: In general, the Act requires that elections to defer compensation must be made in the year prior to the taxable year of the taxpayer in which the compensation is earned (i.e., no later than December 31, 2005, for amounts to be earned in 2006). However, a special rule applies for the first year in which a service provider becomes eligible to participate in the plan if the election is made within 30 days of becoming eligible and such election only relates to amounts earned after such election. The Proposed Regulation clarifies that, when such an election is made after the commencement of the services to which the compensation relates, the election may only relate to a prorated portion of the compensation earned measured from the date of the election to the applicable measurement date. For example, if a new fund commences operations on July 1, 2005, and the investment management agreement permits the investment manager to defer performance fees earned during the 2005 calendar year, the investment manager should be able to make an election within 30 days after July 1, 2005. However, if the investment manager waits the entire 30 days to make an election, the investment manager may only defer approximately 82 percent of the performance fees earned from July 1, 2005, through December 31, 2005.

Q: **When does an initial election need to be made with respect to a fiscal year fund?**

A: In general, the Act requires that elections to defer compensation be made in the year prior to the taxable year of the taxpayer in which the compensation is earned (i.e., no later than December 31, 2005, for amounts to be earned in 2006). Accordingly, for most taxpayers, an election made by December 31, 2005, will satisfy this requirement with respect to compensation earned during the 2006 calendar year. However, an issue exists with respect to compensation that is earned by a calendar year fund manager from a fund that employs a fiscal year that is not a calendar year. The Proposed Regulation provides that, with respect to "fiscal year compensation," the election must be made not later than the last day of the service recipient's fiscal year preceding the fiscal year in which services are performed to which such compensation relates. For example, if a fund has a fiscal year that begins July 1, 2006, the initial election should be made by June 30, 2006. In general, fiscal year compensation means compensation relating to a period of service coextensive with one or more fiscal years, of which no amount is paid or payable during the service period. It does not include amounts that would otherwise be paid during the fiscal year. As such, it appears that this special fiscal year rule could apply to most performance fees that are based on the fund's fiscal year and which are not otherwise payable during such year. However, it would not apply with respect to management fees that are paid other than on a fiscal year basis (e.g., quarterly management fees). In addition, it is unclear whether it could apply with respect to performance fees that become payable during the fiscal year (e.g., performance fees paid upon redemption of an investor's interest in the fund). As such, with respect to a fund manager that desires to defer both management and performance fees for a fiscal year fund, the fund manager would need to elect to defer management fees prior to the beginning of its taxable year in which such fees are payable (i.e., December 31, 2005, for any management fees payable in 2006), but could wait until the beginning of the fund's fiscal year to elect to defer annual performance fees.

Q: **Does the Proposed Regulation address whether the offshore funding rules are violated with respect to the typical offshore fund arrangement?**

A: No. The Treasury will issue guidance in the future with respect to offshore funding arrangements (i.e., where assets used to support a deferred compensation obligation are held outside the United States in trust or other arrangements identified by the Treasury). However, as we indicated in our prior Alerts, although not free from doubt, subject to any future regulations to the contrary, we do not believe that offshore deferred compensation plans will violate the Act's funding rules if the assets are not set aside from the general assets of the fund. This is especially true when the assets of the fund are held in the United States.

Q: **Must the deferred compensation arrangement specify an exact date on which amounts will be paid?**

A: Yes and no. Many deferred compensation arrangements provide that performance fees with respect to a year shall be paid within a reasonable period of time following the date that the fund completes its annual audit and can determine the actual amount due. Under the Act and December Notice, it was unclear whether such a provision could violate the Act since the Act specifically provides that payments can only be made upon the occurrence of certain specified events (which does not include an exception for annual audits). The Proposed Regulation provides that as long as the election sets forth an objectively determinable calendar year in which payment will be made following a permissible payment event, no violation of the Act occurs. Accordingly, if an investment management agreement provides that deferred compensation will be paid during the year following the year to which the election relates, no violation of the Act occurs even though the payment could be made at any time during the following year. Note, in this instance, for purposes of making a re-deferral and measuring the 12-month period prior to the payment date that such a re-deferral election can be made, the amount will be deemed to be payable as of January 1 of the year in which the payment will be made.

Q: **When do deferred compensation arrangements need to be amended for purposes of complying with the Act?**

A: December 31, 2006. However, each deferred compensation arrangement still needs to be operated in "good faith compliance" with the Act as of January 1, 2005.

Q: **Does the Proposed Regulation extend the ability to cancel a deferral election or terminate an arrangement not otherwise subject to the Act beyond December 31, 2005?**

A: No. The Proposed Regulation does not extend many of the transitional provisions contained in the December Notice beyond December 31, 2005.

Q: **Does the Proposed Regulation permit a service provider to change the payment elections with respect to amounts that are subject to the Act?**

A: Yes. Changes in payment elections can be made through December 31, 2006, provided that no changes can be made in 2006 with respect to amounts that would otherwise become payable in 2006 or change payment elections to cause amounts to be paid in 2006.

Q: **Can a taxpayer rely on the Proposed Regulation?**

A: Yes, but reliance is not required. A plan adopted prior to January 1, 2007, will be deemed to have operated in good faith compliance with the Act if it is operated in accordance with the December Notice. Plans are not required to comply with the Proposed Regulation prior to January 1, 2007. However, compliance with the Proposed Regulation will be deemed to be good faith compliance with the Act. Fund managers should review their plans in light of the Proposed Regulation to see whether amendments will be required. In any event, for 2005 and 2006 it is important to determine whether the plan is being operated in compliance with the Act (whether or not the form of the plan currently so complies with the Act).

Q: **Are there other provisions of the Proposed Regulation that could be relevant to a fund manager?**

A: Certainly. The Proposed Regulation, including the Preamble, provides detailed guidance on many aspects relating to the Act. In the interest of time, we have only addressed those issues that we deemed most relevant for fund managers. As we analyze the entire Proposed Regulation, additional Alerts may be forthcoming that address certain other questions a fund manager may have regarding the Act.

Q: **Will additional guidance be issued by Treasury and the IRS?**

A: Yes. The Proposed Regulation is only proposed. Taxpayers have until January 3, 2006, to provide comments on the Proposed Regulation, which will be discussed at a public hearing, scheduled for January 25, 2006. In addition, the Treasury and the IRS reserved on many other aspects of the Act that will be addressed at some point in the future.

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