December 2004

INVESTMENT FUNDS ALERT

UPDATE ON NEW LEGISLATION RELATING TO NONQUALIFIED DEFERRED COMPENSATION PLANS

Please note that this Alert is intended to supplement our Investment Funds Alert, dated October 15, 2004, relating to Nonqualified Deferred Compensation Plans of Hedge Fund Managers. (See http://www.akingump.com/docs/publication/700.pdf)

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 (the IRS) issued Notice 2005-1 (the Notice), which provides interim guidance with respect to the Act as it relates to nonqualified deferred compensation plans. (The IRS has indicated that this Notice is the first of a series.)

Set forth below is a brief summary of certain provisions of the Notice that are of interest to fund managers. In addition, we have identified several areas of concern that fund managers should consider prior to the end of 2004.

HIGHLIGHTS

- Based on the Notice, it is unclear whether the Act applies to most hedge fund managers. Until further guidance is available, we recommend that fund managers assume that the Act applies to their deferred fee arrangements.

- With respect to amounts that relate wholly or in part to services to be performed at any time during 2005, the Notice indicates that any deferral election can be made as late as March 15, 2005, provided such election is made under a plan that was in existence as of December 31, 2004. We note, however, that such an election may relate only to amounts that are not otherwise payable by the date of the election. Therefore, if quarterly or monthly management fees or performance fees become payable or performance fees are earned with respect to redeeming investors prior to such an election, the election will not be effective with respect to those fees. Accordingly, unless a compelling reason exists to delay deferral elections for 2005 compensation, such elections should be made by December 31, 2004.

- The Notice does not address back-to-back arrangements (i.e., plans in which the fund manager's deferral elections to the fund reflect the deferral elections made by the fund manager's employees and partners). Consequently, it is still unclear whether a fund manager will be permitted to take an early withdrawal payment from a fund to satisfy the claim of a departing employee or partner. Accordingly, unless the fund manager can satisfy its obligations to the employees and partners from other sources, it should notify in writing all participating employees and partners that their deferrals may not be paid upon termination of service unless the fund manager is able to take a distribution of its deferred fees from the fund without adversely impacting the deferral plan. This notice should be provided to all participants prior to accepting their deferral elections with respect to 2005 compensation.

- The Notice provides that non-conforming plans do not need to be amended until December 31, 2005, provided that the plan is operated in good-faith compliance with the Act during 2005.

Good-Faith Compliance. In general, a plan adopted before December 31, 2005, will not be treated as violating the provisions of the Act if the plan is operated in good-faith compliance with the Act and the Notice during 2005 and the plan is amended on or before December 31, 2005, to conform to the Act with respect to amounts subject to the Act. As such, plan amendments to comply with the Act are not required until December 31, 2005. If final guidance is more restrictive than the Notice, the IRS has indicated that such restrictive guidance will not apply retroactively.

Therefore, while there is no need to amend existing arrangements at this time, each fund manager should be aware of the substantive provisions of the Act to ensure good-faith compliance. Until more definitive guidance is available, we encourage each fund manager to carefully review with their legal advisors any proposed actions related to deferred compensation arrangements that are subject to the Act.

Effective Date. The Act applies to amounts deferred after December 31, 2004, and amounts deferred in taxable years beginning before January 1, 2005, for plans materially modified after October 3, 2004. The Notice clarifies that an amount is considered deferred before January 1, 2005, if the service provider has a legally binding right to be paid the amount and the right to the amount is earned and vested. If the amount is subject to a substantial risk of forfeiture, it is not earned and vested. For the typical fund manager, its performance fee for 2004 is likely earned and vested as of December 31, 2004, whether or not it is actually payable in 2004. Accordingly, such amounts should not be subject to the Act unless the arrangement that deferred such compensation is materially modified after October 3, 2004.

Material Modification. In general, a modification of a plan is material if a right or benefit that existed as of October 3, 2004, is enhanced or a new benefit or right is added. Prior to amending any existing arrangement, a fund manager must understand the implications of making amounts subject to the Act. For example, if a fund manager were to elect to re-defer certain amounts not otherwise subject to the Act under an arrangement that did not provide for re-deferrals, such re-deferral would likely be viewed as a material modification and all amounts deferred under such deferred compensation arrangement could become subject to the Act. Accordingly, if the arrangement provided for back-to-back deferrals prior to the re-deferral, it may not be possible to continue such back-to-back deferrals for any amounts deferred under the arrangement, not just the re-deferred amount.

Does the Act Apply to Fund Managers? In general, the Notice provides that the Act only applies to "service recipients" and "service providers." Although not free from doubt, until further guidance is available, we believe that it is prudent to assume that a typical fund manager is a service provider for purposes of the Act.

Assuming that we are correct that a typical fund manager is a service provider for purposes of the Act, the Notice provides that an arrangement between a service provider and a service recipient will not be subject to the Act if (i) the service provider is actively engaged in the trade or business of providing substantial services, other than as an employee or director of a corporation and (ii) the service provider provides services to two or more service recipients to which the service provider is not related and that are not related to one another. Based on the Notice, it is arguable that certain of a fund manager's relationships may fit within this exception.

Late Elections and Bonus Compensation. The Notice clarifies that with respect to plans in existence prior to January 1, 2005, elections to defer compensation for services performed on or before December 31, 2005, that are made on or before March 15, 2005, will be timely under the Act if (i) the amounts have not been paid or become payable when the election is made and (ii) the election is made in accordance with the terms of the plan in effect on or before December 31, 2005. As such, if a fund manager fails to make an election by December 31, 2004, under its existing deferred compensation arrangement, based on the Notice, it still should be able to elect to defer its 2005 performance fees effectively if it elects to do so by March 15, 2005. However, such an election may not apply with respect to any fees actually paid or payable prior to the date of the election (e.g., management fees or performance fees earned with respect to redeeming investors). Accordingly, unless a compelling reason exists to delay making elections with respect to 2005 compensation, such elections should be made by December 31, 2004.

Except for this limited exception, elections to defer compensation must generally be made in the taxable year prior to the taxable year in which the compensation is earned. There is a limited exception for performance-based compensation payable over a period of at least 12 months where the election must be made at least six months prior to the end of the performance period. The Notice provides that this rule is applicable to compensation where (i) the payment of the compensation is contingent on the satisfaction of organizational or individual performance criteria and (ii) such criteria are not substantially certain to be met at the time the deferral election is made. Although it appears that a fund manager's performance fee could meet this criterion, until further guidance is available, it would be prudent not to rely on this exception.

Right to Cancel Deferrals. Any plan adopted before December 31, 2005, may be amended to allow a participant to terminate or cancel a deferral election with regard to amounts deferred that are subject to the Act. Amendments relating to the termination or cancellation of a deferral must be made by December 31, 2005, and such amounts must be included in income for the year of cancellation.

Informational Reporting. Effective for amounts deferred in calendar years beginning after December 31, 2004, if a Form 1099-MISC or W-2 is required to be filed by a service recipient, it must reflect the amount of deferred compensation for such year regardless of whether it is includible in income. This requirement also applies to any notional income on such amounts.

Uncertainties. Although the Notice provides broad transitional relief, it does not address many of the issues raised by the Act, especially in the context of hedge fund managers' deferred compensation arrangements. In addition, the Notice does not address many of the operational provisions of the Act (i.e., distributions, plan amendments, etc.).

1. ***Back-to-Back Arrangements.*** The Notice does not address back-to-back plans. For example, if an employee elects to be paid his compensation from the fund manager upon separation from service, the fund manager typically elects to defer its fees until the earlier of a specified period of time that mirrors the time period elected by the employee, or the occurrence of an event such as the employee's separation of service. It is unclear under the Act whether this is permissible, since the distribution event for the employer is based upon an event that is not its own separation from service.

   Since the Act's application to these arrangements is still unclear, fund managers will need to consider whether they wish to continue these programs absent guidance that specifically sanctions such arrangements. It is our current view that, with respect to amounts "earned and vested" after December 31, 2004, back-to-back arrangements should be suspended to the extent the fund manager would seek an earlier distribution of fees based on non-time-specific events related to participants in the fund manager's plan (e.g., death, disability or termination of service of the participant). Accordingly, a fund manager will need to decide whether it will permit participants in its deferred compensation arrangements to receive funds prior to the time that the investment management entity itself is scheduled to receive compensation from the fund. Ultimately, this decision is likely to depend on whether the fund manager can satisfy its own deferred compensation liabilities to participants from other sources.

   If a fund manager decides to permit participant distributions only after the fund manager has received compensation from the fund, each participant should be contacted to alert the participant of such change. In addition, the election notice for such year should specifically state that no distributions will be made upon the occurrence of a participant's termination of service. If a plan is not revised prior to accepting a deferral election, it may not be possible for the fund manager to preclude payouts to a participant on termination.

2. ***Offshore Arrangements.*** Both houses of Congress have passed the Tax Technical Corrections Act of 2004 (TTCA), which the president is expected to sign into law. Under TTCA, Congress has clarified the effective date of the Act as it relates to the transfer of assets offshore to secure deferred compensation obligations. If amounts are held in trust (or other arrangements identified by the Treasury Department) outside of the United States to secure deferred compensation obligations, such amounts become taxable (and subject to penalties) once they are set aside. This rule is effective as of January 1, 2005, whether or not the deferred compensation obligations relate to amounts earned and vested after December 31, 2004. The Treasury Department will provide guidance with respect to arrangements that already violate this rule within 90 days after TTCA is signed into law.

   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. Accordingly, TTCA is not likely to be relevant for most fund managers in this regard. However, if our belief is incorrect, TTCA could effectively terminate all offshore deferred compensation arrangements, including with respect to amounts deferred prior to December 31, 2004.

3. ***Fiscal Year Funds.*** 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, 2004, for amounts to be earned in 2005). Accordingly, for most taxpayers, an election made by December 31, 2004, will satisfy this requirement with respect to compensation earned during the 2005 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. If a fund's fiscal year is July 1 to June 30, when would an election by a calendar year fund manager to defer compensation need to be made under the Act with respect to the fiscal year commencing on July 1, 2005? The answer to this question is not clear. Until guidance is available, a calendar year fund manager should make the election no later than December 31, 2004 (or March 15, 2005, if the exception discussed above is applicable).

* * * *

AKIN GUMP
STRAUSS HAUER & FELD LLP
Attorneys at Law

CONTACT INFORMATION

If you have any questions concerning this Alert or would like further information on nonqualified deferral arrangements or other related matters, please contact:

David M. Billings	+44.20.7012.9620	dbillings@akingump.com	London
Patrick B. Fenn	212.872.1040	pfenn@akingump.com	New York
Stuart E. Leblang	212.872.1017	sleblang@akingump.com	New York
Prakash H. Mehta	202.887.4248	pmehta@akingump.com	Washington
Eliot D. Raffkind	214.969.4667	eraffkind@akingump.com	Dallas
Adrienne A. Scerbak	212.872.1056	ascerbak@akingump.com	New York
Bruce E. Simonetti	212.872-8023	bsimonetti@akingump.com	New York
Ann E. Tadajweski	212.872.1087	atadajweski@akingump.com	New York
Stephen M. Vine	212.872.1030	svine@akingump.com	New York

Austin Brussels Dallas Houston London Los Angeles Moscow New York
Philadelphia Riverside Riyadh (Affiliate) San Antonio San Francisco Washington, D.C.

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.

akingump.com