

TAX ALERT

NEW SECTION 457A, WHICH LIMITS DEFERRAL OF OFFSHORE COMPENSATION, IS SIGNED INTO LAW

EXECUTIVE SUMMARY

On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (H.R. 1424), which adds new Section 457A to the Internal Revenue Code (the "Code"). As discussed below, Section 457A imposes significant restrictions on techniques commonly used by managers of offshore hedge funds to defer fee income. The restrictions generally apply only to deferred compensation attributable to services rendered after 2008.

Section 457A contains limited transition relief for deferred compensation attributable to services performed before January 1, 2009. Although some aspects of Section 457A are unclear (particularly with respect to side pockets), the transition relief generally allows continued deferral of pre-2009 deferred compensation amounts until 2017.

Given the very limited time window for which transition relief is being granted, we think it would be prudent for fund managers to consider before year end certain planning techniques to take maximum advantage of the transition relief afforded under Section 457A and to consider compensation arrangements going forward to address the new challenges posed by Section 457A.

DISCUSSION OF SECTION 457A

Section 457A is aimed squarely at a common technique used to defer fee income from foreign hedge funds. Section 457A is intended to apply in addition to the requirements of Section 409A. Thus, Section 409A's restrictions on deferred compensation will continue to apply in addition to the new restrictions imposed by Section 457A. We note, however, that there are certain inconsistencies between Section 457A and Section 409A that will need to be addressed in future regulations or guidance.

Section 457A requires taxpayers to include in income compensation that is deferred under a "nonqualified deferred compensation plan" of a nonqualified entity, provided that the income is not subject to a "substantial risk of forfeiture." Compensation is not treated as deferred (and current income inclusion is not required) under Section 457A if the service provider receives

payment of the compensation no later than 12 months following the end of the nonqualified entity's taxable year during which the right to payment of such compensation is no longer subject to a substantial risk of forfeiture. However, this limited deferral right will need to be coordinated with deferral provisions under Section 409A.

For purposes of Section 457A, the term "nonqualified deferred compensation plan" generally has the same meaning as under Section 409A(d), but also includes any arrangement under which compensation is based on the increase in value of a specified number of equity units of the service recipient, including stock appreciation rights ("SARs"), regardless of the exercise price of the SARs.

Section 457A contains a more restrictive definition of "substantial risk of forfeiture" than the definition contained in Section 409A. Under Section 457A, a person's right to compensation is treated as subject to a substantial risk of forfeiture only if such right is conditioned upon the "future performance of substantial services by any individual." Thus, while under Section 409A an individual's right to compensation may be considered subject to a substantial risk of forfeiture if such compensation is conditioned upon the achievement of certain performance objectives, under Section 457A, only time-based vesting restrictions qualify as a substantial risk of forfeiture. It is unclear whether the Internal Revenue Service will adopt rules under Section 457A similar to those under Section 409A relating to acceleration of payments upon certain involuntary terminations or other events beyond the control of the service provider.

Section 457A may apply to accrual-method service providers as well as to cash-method service providers, whereas Section 409A applies only to cash-method service providers. Under the House's proposed version of Section 457A, "service provider" would have had the same meaning given to the term in the regulations under Section 409A, except that the service provider's method of accounting would have been irrelevant. Although the final version of Section 457A does not specifically define "service provider," it is possible that Section 457A may reach service providers irrespective of their method of accounting. If Section 457A is treated as applying to accrual-method service providers, KeySOP arrangements and side pocket performance fees could be significantly adversely impacted.

Section 457A applies to deferred compensation that is attributable to services performed after December 31, 2008. Deferrals of compensation attributable to services performed before January 1, 2009 and not subject to a substantial risk of forfeiture (as defined above) are subject to a grandfather rule that allows continuation of deferral until 2017 (or, in the case of fiscal-year entities, until the last taxable year beginning before 2018). Deferred compensation attributable to pre-2009 services and subject to a substantial risk of forfeiture beyond 2017 will be required to be included in income in the taxable year in which the compensation is no longer subject to a substantial risk of forfeiture. For pre-2009 deferred compensation that is payable prior to 2017, Section 457A does not explicitly address "redeferrals" (i.e., elections to extend the deferral period), which Section 409A permits in limited circumstances provided such elections are called for in the deferred compensation plan.

If the amount of any deferred compensation is not determinable at the time the compensation would otherwise be includible in gross income under Section 457A, such compensation must be taken into account when it becomes determinable. In addition to the income tax generally applicable under the Code, such compensation is subject to a 20% penalty tax plus an interest charge (at the underpayment rate plus 1%) as if the deferred compensation had been includible in the taxpayer's income as of the time the income was not subject to a substantial risk of forfeiture. This punitive regime may have a significant adverse impact on performance-based fees relating to side pocket investments of offshore funds where the fees are generally not determinable, and not payable, until the side pocket investment is sold. It should be noted that side pocket fees may already be problematic under Section 409A.

Apparently as a relief measure, Section 457A contemplates regulations that would treat compensation determined solely by reference to the amount of gain recognized on the disposition of an “investment asset” as subject to a substantial risk of forfeiture until the date of such disposition. The term “investment asset” includes any single asset acquired directly by an investment fund, if neither the fund nor a related party participates in the active management of such asset and if gains on the disposition of such asset (other than the deferred compensation element) are allocated to investors in the fund. This provision does not appear to be self-executing, and in any event it is unclear whether the provision will provide substantial relief in the case of performance-based fees relating to side pocket investments.

The House version of Section 457A contained an additional grandfather rule that apparently would have provided transition relief for compensation payable under a binding written contract entered into before 2008 with respect to side pocket investments held by the service recipient as of the date of enactment of Section 457A. However, this transition relief was not included in the final version of Section 457A. Additionally, although earlier versions of Section 457A would have permitted service providers to make charitable contributions of pre-2009 deferred compensation amounts without regard to certain limits otherwise contained in the Code, this relief measure was not included in the final version of the legislation.

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