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# INVESTMENT FUNDS ALERT

## NEW LEGISLATION RELATING TO NONQUALIFIED DEFERRED COMPENSATION PLANS

Congress has passed, and President Bush is expected to sign into law, the American Jobs Creation Act of 2004 (the Act). The Act addresses many areas of federal taxation, including the design and treatment of nonqualified deferred compensation plans, such as the typical deferred compensation plan created by hedge fund managers that defers performance fees and indexes them to fund performance during the deferral period. This Alert provides an initial summary of the provisions of the Act most relevant to U.S.-based hedge fund managers that benefit from deferred compensation plans. We expect to deliver a more detailed description of the provision as new issues and details emerge based on further examination of the provisions and the expected issuance of Treasury Department guidance.

The legislation does not repeal the basic principles underlying the typical hedge fund deferral program and thus does not prohibit such programs provided that they are properly structured. However, certain of the Act's provisions grant the Treasury Department broad discretion to issue interpretive guidance, and it is possible that future Treasury Department regulations could determine that certain provisions of the Act should be interpreted as prohibiting (presumably on a prospective basis) hedge fund managers from deferring compensation with respect to offshore hedge funds. In light of the substantial penalties that will apply for noncompliance, hedge fund managers must carefully consider the Act and its application to their deferred compensation arrangements.

As discussed more fully below, of particular importance are the following provisions:

- The Act is effective for amounts earned and deferred after December 31, 2004. This means that all deferral elections made with respect to compensation earned for services performed on or after January 1, 2005, will have to comply with the Act. Regulations should provide some transitional relief regarding compliance with the Act for deferrals of amounts after December 31, 2004. However, hedge fund managers will only have a limited amount of time to amend existing arrangements concerning deferral elections for 2005 to comply with the Act.

- For purposes of the effective date, an amount is considered deferred before January 1, 2005, if the amount is earned and vested before such date. To the extent there is no material modification after October 3, 2004, present law applies with respect to vested rights. Accordingly, provided that a fund manager's fees are earned and vested as of December 31, 2004 (whether or not actually payable in 2004), any prior deferral elections relating to such fees should not be subject to the Act.

- The Act restricts the types of events that may accelerate the payment of deferred compensation. Many hedge fund managers will need to modify their deferred compensation plans to reflect these new limitations on the acceleration of payments. For example, so-called "haircut" provisions will no longer be permissible. In addition, it is unclear whether acceleration events related to changes in tax law will be permissible.

- The Act provides specific limitations as to the timing of deferral elections. Since the timing limitations are similar to limitations that are already included in many plans, most hedge fund managers will be familiar with these provisions. The Act provides that in certain limited circumstances, elections relating to incentive compensation earned over a period of at least one year may be made at least six months prior to the end of the performance period. Depending on how regulations interpret this provision, this may provide fund managers more liberal election procedures with respect to certain incentive fees.

- The Act has uncertain application with respect to deferral arrangements between entities (e.g., a fund manager and a fund), and potentially restricts the use of so-called "back-to-back" plans (plans in which the hedge fund manager's deferral elections to the offshore fund reflect the deferral elections made by the hedge fund manager's employees). As many hedge fund managers sponsor back-to-back plans, it will be critical to evaluate the conditions under which these plans may be maintained.

- The Act specifically allows for re-deferrals (i.e., extensions of an elected deferral period) based on specific procedures and limitations. Previously, the legal consequences of re-deferrals had been uncertain. The existence of the new rules may provide significant comfort regarding the use of re-deferrals, as well as potential planning possibilities regarding the length of initial deferral elections.

- The Act provides that assets set aside (directly or indirectly) in trust (or "other arrangements" determined by the secretary of the treasury) for purposes of paying deferred compensation will be immediately taxable, to the extent vested, if they are held or transferred offshore (whether or not available to satisfy claims of general creditors). Because of the uncertain application of this rule, offshore fund managers with deferred compensation arrangements will need to give careful consideration to where the assets related to such deferred compensation are located. Although not free from doubt, absence specific guidance to the contrary, we do not believe that this rule should be applicable with respect to typical offshore deferred fee arrangements where assets relating to such deferred fees are not held in a trust vehicle or otherwise segregated from the assets of the fund. However, given the uncertain application of this rule, it is arguably safer to directly hold such assets in a U.S. brokerage account of the offshore fund.

- The Act includes new reporting requirements for deferred compensation.

**What does the Act provide?**

The Act creates new Section 409A of the Internal Revenue Code of 1986, as amended (the Code), which provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in income unless (i) such compensation is subject to a substantial risk of forfeiture (e.g., vesting) or (ii) the requirements of the Act are satisfied. Since most deferred compensation arrangements for fund managers are not subject to a substantial risk of forfeiture, compliance with the Act is a necessity with respect to amounts deferred after December 31, 2004.

**What is the penalty for violating the Act?**

If the requirements of the Act are not satisfied, in addition to current income taxation, the Act imposes a 20 percent penalty on the amount that must be included in income as well as interest equal to the underpayment rate plus 1 percent from the date such income should have been included in income. This also applies to "earnings" on improperly deferred amounts. This penalty applies on a participant-by-participant basis. That is, if one participant's deferral violates the Act, such violation should not affect other participants' deferrals under the same plan.

**What is a nonqualified deferred compensation plan?**

Any agreement or arrangement (including an agreement or arrangement with one person) that provides for the deferral of compensation (other than qualified plans and certain other bona fide welfare-type plans) is covered by the Act. It does not make a difference whether the plan is elective or mandatory.

The Act clearly governs deferred compensation arrangements in the individual service provider/service recipient relationship (e.g., employer/employer). It is unclear how it may apply to an entity that elects to defer receipt of income (e.g., a fund manager electing to defer its performance fees from a fund). Until further guidance is available, it is prudent to operate such arrangements as though they are subject to the Act. We note that the Joint Committee Report relating to the Act (the Report) provides that the definition is not limited to arrangements between an employer and employee. We therefore expect that the Act will be interpreted broadly.

**What are the requirements of the Act?**

***Distribution Events and Acceleration of Benefits.*** The requirements of the Act are met if the plan provides that compensation deferred under the plan may not be distributed earlier than: (i) separation from service, (ii) serious disability (as specifically defined in the Act) likely to lead to death or expected to last for 12 consecutive months, (iii) death, (iv) a specified time (or pursuant to a fixed schedule) specified under the plan at the time the deferral election is made, (v) a change of ownership of an employing corporation or (vi) the occurrence of an unforeseeable emergency (as specifically defined) provided that the distribution is limited to the amount necessary to satisfy the emergency.

These permissible distribution events have a clearer meaning in the context of an employer/employee relationship, and it is unclear how they might apply in the context of a partner's share of the partnership's offshore performance fees, especially in the context of a non-service partner. For example, it is unclear whether a deferred fee arrangement could provide for the acceleration of fees in the event a non-service partner withdraws from the partnership. In addition, many deferred fee arrangements provide for the acceleration of deferrals based on changes in the tax law. Such provisions may no longer be permissible with respect to post-December 31, 2004, deferrals.

Since event-based triggers other than those specifically set forth above will no longer be permissible, hedge fund managers will need to review existing nonqualified deferred compensation plans to ensure that such impermissible provisions are eliminated with respect to deferrals made after December 31, 2004.

Of particular concern are back-to-back plans in which an employer (i.e., the hedge fund manager) makes a matching election on behalf of its employees with respect to its own deferred compensation agreement with an offshore fund. For example, if an employee elects to be paid his compensation from the investment manager upon separation from service, the hedge 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. Although we are hopeful that interpretive guidance may be issued on this point, it is possible that back-to-back plans may have to be amended to eliminate certain deferral events that are permissible for the employee, but are not permissible for the hedge fund manager.

Except as may be provided by regulation,[1] a plan will fail to meet the requirements of the Act to the extent the plan permits the acceleration of the timing or schedule of payment. Accordingly, plans that contain so-called "haircut" provisions (e.g., a provision that will permit early distribution upon payment of a penalty) will not meet the requirements of the Act with respect to deferrals made after December 31, 2004. It appears that existing plans can continue to offer such features with respect to pre-December 31, 2004, deferrals.

***Timing of Participant Elections and Distribution Options.*** Under the Act, except as provided by regulation, participant elections to defer compensation will need to be made no later than the close of the tax year that precedes the year with respect to which such compensation relates. For the first year in which a participant is eligible to participate in a plan, the election may be made within 30 days after the date the participant is eligible to participate in the plan. Many existing non-qualified deferred compensation plans already meet this timing requirement. A limited exception applies with respect to performance-based compensation that is earned for services performed over at least a 12-month period. In such a case, deferral elections can be made no later than six months before the end of the performance period.[2] Whether this might present planning opportunities for fund managers with respect to incentive fees is uncertain.

The election made by a participant must specify the time at which payment will be made (e.g., in three years) and the form of payments (lump sum or installments over a certain period of time).

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1 It is anticipated that any such regulations may include events such as payments made incident to a court-approved divorce, to comply with federal conflict of interest laws, or the withholding of the employees' shares of employment taxes.

2 The Report indicates that performance-based compensation will have a meaning similar to that set forth in Section 162(m) of the Code. Therefore, at the very least, the compensation amount should be variable and contingent upon the satisfaction of performance criteria that are not certain to be reached at the time the deferral election is made.

This may be of particular concern for fund employees whose bonus may be variable, but not necessarily based on pre-established goals. Until further guidance is issued, it would be prudent to require that all elections be made in the year prior to the year in which the services are rendered.

***"Re-deferrals" and Changes in the Form of Distribution.*** In general, the Act permits a plan to allow changes in the time and form of distribution. Accordingly, a plan may allow a re-deferral or change in the form of distribution if (i) the election does not become effective for at least 12 months, (ii) except in the case of elections relating to death, disability or unforeseeable emergency, the plan requires that the additional deferral is made for a period of not less than five years from the date such payment would have otherwise been made and (iii) the plan requires that an election related to a distribution to be made at a specified time may not be made less than 12 months prior to the date of the first scheduled payment.

Although not specifically addressed, it appears that unlimited additional re-deferrals may be made provided that the above-mentioned requirements are met. Nonetheless, the law does not create an automatic safe harbor, and existing rules relating to constructive receipt still need to be analyzed as they relate to additional re-deferrals. The Act is also unclear as to whether the terms of the existing plan must explicitly permit re-deferrals. Until further guidance is available, it would be prudent to specifically provide for re-deferrals in plan documents. It remains unclear whether amending an existing plan to permit a re-deferral would be deemed to be a material modification of the plan and result in adverse tax consequences.

***Funding.*** The Act generally provides that if assets are set aside in a trust (or other arrangement determined by the secretary of the treasury) for purposes of paying deferred compensation, such assets shall be treated as a taxable transfer of property under Section 83 of the Code to the extent such assets are located or transferred outside of the United States. In general, this does not apply to assets located outside of the United States if substantially all of the services to which the nonqualified deferred compensation relates are performed in the jurisdiction where the assets are held.

As noted above, given the uncertain application of this rule, offshore fund managers with deferred compensation arrangements will need to carefully consider where the assets related to such deferred compensation are located until more definitive guidance is available.

### How does the Act treat "earnings"?

Notional income attributable to nonqualified deferred compensation is treated as additional deferred compensation and is subject to the Act. However, earnings on deferred compensation attributable to amounts not subject to the Act (e.g., amounts deferred prior to December 31, 2004) are only subject to the Act to the extent the compensation to which they relate becomes subject to the Act (e.g., the existing deferral agreement or plan is materially modified). Accordingly, it appears that the Act should not have an adverse impact with respect to "earnings" on prior deferrals.

### Are there any new reporting requirements?

The Act requires companies to report nonqualified deferred compensation on an individual's W-2 or Form 1099 for the year deferred even if the amount is not included as income for that taxable year. It is unclear whether this has any effect with respect to a partner's share of the partnership's deferral of performance fees.

### When is the Act effective?

The Act is effective for all amounts deferred after December 31, 2004. In addition, in order to prevent the addition of plan amendments with respect to pre-2005 deferrals for the rest of the year, amounts deferred prior to December 31, 2004, are subject to the Act if the plan under which the deferral is made is materially modified after October 3, 2004. Accordingly, no existing plans or deferral arrangements should be modified, except as provided below.

For purposes of the effective date, an amount is considered deferred before January 1, 2005, if the amount is earned and vested before such date. To the extent there is no material modification after October 3, 2004, present law applies with respect to vested rights. Accordingly, provided that a fund manager's fees are earned and vested as of December 31, 2004 (whether or not actually payable in 2004), any prior deferral elections relating to such fees should not be subject to the Act.

The Act provides that no later than 60 days after enactment, the secretary of the treasury will issue guidance that will provide a limited period of time during which plans adopted before December 31, 2004, may be amended to permit a participant to terminate participation in the plan or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004. In addition, during that window period, existing plans may be amended to conform with the Act with respect to amounts deferred after December 31, 2004.

**What should you do to comply with the Act?**

Each entity that maintains a deferred compensation plan or arrangement should carefully review its terms in light of the Act. Given the substantial penalties associated with noncompliance, hedge fund managers may want to consider freezing current deferred compensation plans for all deferrals made prior to December 31, 2004, and adopting a new plan applicable to post-2004 deferrals. Elections under the new plan should be made before December 31, 2004, with respect to 2005 income.[3] Alternatively, hedge fund managers may consider amending existing plans based on the regulations that are supposed to be issued within 60 days of the enactment.

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## 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.

3 The Act is silent with respect to automatic deferral arrangements, which are typical under many investment manager agreements.