

Alert

Tax Legislation Limits Future Deferrals, Penalizes Future Side Pocket Incentive Fees from Offshore Funds

October 7, 2008

On Oct. 3, 2008, the Emergency Economic Stabilization Act of 2008 (H.R. 1424) was signed into law. The Act, among other things, eliminates the ability of most cash-basis taxpayers¹ to defer compensation earned from many non-U.S. corporations (including offshore hedge funds) and certain partnerships comprised primarily of persons non-taxable in the United States ("nonqualified entities"). **The legislation is effective for compensation attributable to services performed after Dec. 31, 2008.**²

The law adds new Section 457A to the Internal Revenue Code of 1986, as amended (the "Code"), which requires the inclusion in a taxpayer's income of compensation deferred from a nonqualified entity under a nonqualified deferred compensation plan when such income is not subject to a substantial risk of forfeiture. For purposes of this rule, a "substantial risk of forfeiture" is limited only to the taxpayer's continued performance of substantial services (i.e., to avoid Section 457A, the taxpayer must forfeit the deferred compensation if the taxpayer ceases to provide substantial services to the fund prior to the end of the specified deferral period). However, payment of the compensation may be made up to 12 months following the end of the nonqualified entity's taxable year without triggering the income-inclusion rules.

Of particular note is a provision that negatively impacts performance-based fees on "side pocket" arrangements of an offshore hedge fund and certain other offshore fund fees based on performance measured over a period of more than 12 months.³ The amount of such fees is generally not known, and such fees are generally not payable, until the side pocket is realized. However, because fees from a side pocket are typically not subject to a Section 457A "substantial risk of forfeiture" at a time prior to the realization of the side pocket, Section 457A generally imposes (i) an additional 20% tax and (ii) interest on such fees at the underpayment rate plus 1% when the amount of the fee is determinable (i.e., when the side pocket is realized). Although Section 457A authorizes regulations to allow for a limited exception for a fee payable upon the disposition of a single investment asset, Section 457A and its legislative history appear to exempt very few of the typical side-pocket arrangements and specifically would not exempt funds that net the performance of side pockets with the performance of other investments in computing the managers' fees. Managers should consult their advisers regarding their compensation arrangements for 2009 and future years.

¹ An earlier proposal adopted by the House of Representatives at the end of September would have also applied the rules to accrual method taxpayers. That proposal was not adopted in the final bill.

² Deferrals of fees attributable to services rendered on or prior to Dec. 31, 2008, and earnings on existing deferrals, are generally required to be included in the service provider's income no later than 2017.

³ This could include, for example, certain fees earned as part of a "slow pay" arrangement or a performance-based fee that is calculated over a multi-year period (e.g., a fee payable based on 36 months of performance).

Certain offshore funds currently operate in a “mini-master” format, where the offshore fund and the manager, or its affiliate, are partners in an entity treated as a partnership for U.S. tax purposes (the “mini-master”), which makes the investments and allocates profits, including profits from side pockets, to the manager or its affiliate. **Such mini-master arrangements, as well as performance-based allocations involving onshore funds, are generally not subject to the adverse rules of Section 457A.**

The Treasury Department has been directed to issue transition relief by Jan. 31, 2009, to allow taxpayers to shorten their deferred compensation elections relating to pre-2009 services to the time that Section 457A requires them to include such compensation in their income. Such changes will not violate Section 409A or constitute a "material modification" of compensation not currently subject to Section 409A. The relief will also extend to "back-to-back" deferral arrangements with the managers' personnel.

Please note that Section 409A continues to apply to nonqualified deferred compensation that was not earned and vested as of Dec. 31, 2004 (or that was “materially modified” after Oct. 3, 2004). Any such deferral arrangement must be brought into written compliance with Section 409A by Dec. 31, 2008, in order to avoid significant penalties under that Code section. In addition, Section 409A transition relief that allows taxpayers to change certain payment dates for previously deferred amounts may continue to be used through Dec. 31, 2008. (See [“Deadline for Complying with the Final Section 409A Regulations”](#) (SRZ Client Alert, Aug. 28, 2008), regarding the deadline for taxpayers to amend their agreements to comply with Section 409A and to make certain payment change elections.)

If you have any questions concerning this Alert, please contact:

Philippe Benedict	+1 212.756.2124	philippe.benedict@srz.com
Yehuda M. Braunstein	+1 212.756.2443	yehuda.braunstein@srz.com
Stephanie R. Breslow	+1 212.756.2542	stephanie.breslow@srz.com
Josh Dambacher	+44 (0) 20 7081 8044	josh.dambacher@srz.com
Ida Wurzinger Draim	+1 202.729.7462	ida.draim@srz.com
David J. Efron	+1 212.756.2269	david.efron@srz.com
Marc E. Elovitz	+1 212.756.2553	marc.elovitz@srz.com
Nick Fagge	+44 (0) 20 7081 8009	nick.fagge@srz.com
Steven J. Fredman	+1 212.756.2567	steven.fredman@srz.com
Dominique Padilla Gallego	+1 212.756.2332	dominique.gallego@srz.com
Kenneth S. Gerstein	+1 212.756.2533	kenneth.gerstein@srz.com
David S. Griffel	+1 212.756.2428	david.griffel@srz.com
Udi Grofman	+1 212.756.2298	udi.grofman@srz.com
Peter J. Halasz	+1 212.756.2238	peter.halasz@srz.com
Philip A. Heimowitz	+1 212.756.2583	philip.heimowitz@srz.com
Christopher Hilditch	+44 (0) 20 7081 8002	christopher.hilditch@srz.com
Daniel F. Hunter	+1 212.756.2201	daniel.hunter@srz.com
Dan Kusnetz	+1 212.756.2095	dan.kusnetz@srz.com
Karen J. Loga	+1 212.756.2156	karen.loga@srz.com
Kelli L. Moll	+1 212.756.2557	kelli.moll@srz.com
David Nissenbaum	+1 212.756.2227	david.nissenbaum@srz.com
Omoz Osayimwese	+1 212.756.2075	omoz.osayimwese@srz.com
Kurt F. Rosell	+1 212.756.2099	kurt.rosell@srz.com
Sander B. Ross	+1 212.756.2508	sander.ross@srz.com
Paul N. Roth	+1 212.756.2450	paul.roth@srz.com
Jesse R. Rubin	+1 212.756.2504	jesse.rubin@srz.com
Phyllis A. Schwartz	+1 212.756.2417	phyllis.schwartz@srz.com
Daniel S. Shapiro	+44 (0) 20 7081 8001	daniel.shapiro@srz.com
George M. Silfen	+1 212.756.2131	george.silfen@srz.com
Shlomo C. Twerski	+1 212.756.2510	shlomo.twerski@srz.com
Alan S. Waldenberg	+1 212.756.2501	alan.waldenberg@srz.com
Kerrie Walsh	+44 (0) 20 7081 8008	kerri.walsh@srz.com
Marc Weingarten	+1 212.756.2280	marc.weingarten@srz.com

New York

919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

www.srz.com

Washington, DC

1152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

London

Heathcoat House
20 Savile Row, London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax

“U.S. Treasury Circular 230 Notice: Any U.S. federal tax advice included in this communication was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. federal tax penalties.”

This information has been prepared by Schulte Roth & Zabel LLP (“SRZ”) for general informational purposes only. It does not constitute legal advice, and is presented without any representation or warranty as to its accuracy, completeness or timeliness. Transmission or receipt of this information does not create an attorney-client relationship with SRZ. Electronic mail or other communications with SRZ cannot be guaranteed to be confidential and will not (without SRZ agreement) create an attorney-client relationship with SRZ. Parties seeking advice should consult with legal counsel familiar with their particular circumstances. The contents of these materials may constitute attorney advertising under the regulations of various jurisdictions.