Alert

Twilight of the Deferred Fees: Planning for 2017

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In 2008, President George W. Bush signed into law the Emergency Economic Stabilization Act of 2008 (H.R. 1424), which, among other things, effectively ended the ability of most investment fund managers to defer fees they earned from the offshore funds they managed by virtue of the introduction of Section 457A into the U.S. Internal Revenue Code of 1986, as amended (the "Code"). That legislation, however, grandfathered deferred fees earned for services rendered prior to 2009, provided that such amounts were included in the managers' income no later than calendar year 2017.[1]

Eight years later, many managers still have significant amounts of pre-2009 deferred fees owing to them that are payable in the next 12-13 months. Below are certain tax and other considerations of which managers should take note as they plan for the inevitable end of the deferral era.

Section 409A

Pre-2009 fees that have been deferred by managers using the cash method of tax accounting (i.e., almost all such deferred fees) are still subject to Section 409A of the Code. Managers should review their deferral elections and make sure that payment is made at the times provided for in their plans and elections or discuss with their advisers as to whether any modifications are permissible.[2] Failure to comply with Section 409A of the Code can lead to an additional tax equal to 20 percent of the entire amount deferred, as well as additional interest on the amount deferred going back to the tax return due date for the initial year of deferral. Moreover, any deferred fee agreements that are part of a "back-to-back" arrangement need to be operated such that both the payment by the fund to the manager and the related distribution or payment by the manager to its partners and employees comply with Section 409A of the Code.

Side Pockets

Deferred fees that are indexed to the performance of a fund may be partially indexed to side pockets. While an investor in the fund generally cannot voluntarily redeem from a side pocket, the manager still must be paid the value of the deferral that is indexed to the side pocket, i.e., the manager cannot treat itself from a payment timing standpoint the way it would a shareholder. The manager should be prepared to: (i) be paid such amounts in kind, including in the form of shares of the fund that track the

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[1] In the rare circumstance where a manager had subjected itself to a substantial risk of forfeiture that required its continued provision of substantial services to receive the fee, the deferral could have lasted through such later year beyond 2017 if such risk still existed at such later time.

[2] For example, if a payment had previously been elected to be made on Jan. 1, 2017, a violation of Section 409A of the Code generally would not occur if the payment were instead made on July 1, 2017. However, a payment that was previously elected to be made on July 1, 2017 would generally violate Section 409A of the Code if it were made on Jan. 1, 2017.

side pocket (see also "Payment in Kind" below), and (ii) pay full U.S. federal, state and local income tax on that value even though the manager is not being paid in cash.

Size of Deferral/Portfolio Management

Managers should start planning now, if they have not already done so, how to pay the deferred fees on time. The fund will generally need to liquidate assets or use available cash to pay out the deferred fees, so consideration should be given to what impact that will have on the fund's portfolio. If the deferred fees represent a significant portion of the fund, for example, the manager may want to consider gradually changing how the deferred fees are indexed. Many deferred fee agreements allow the manager, with the fund's consent and at predetermined times, to elect to have its fees indexed to other assets.

For example, if as of Dec. 1, 2016, the deferred fees represented 25 percent of the fund's gross assets, the fund's cash accounts were generally de minimis and the fees were due to be paid on Dec. 31, 2017, the manager might consider electing to index a portion of those fees to treasury bills or other cash-equivalent assets over time (e.g., 5 percent on each of Jan. 1, 2017, April 1, 2017, July 1, 2017 and Oct. 1, 2017, or use some other pre-set formula) rather than cashing out 25 percent of the fund's managed portfolio at the end of 2017.

Another situation certain managers should consider addressing is what to do with the indexing of the deferred fees if the fund is in liquidation. As an example, assume that a manager had previously elected Dec. 1, 2017 as the payment date for its deferred fees, but that the fund is in liquidation as of Jan. 1, 2017 and is paying out its investors as and when it monetizes its remaining positions. Under the deferral agreement and Section 409A of the Code, the manager generally may not be paid until the earlier of Dec. 1, 2017 and the termination of the manager's services to the fund (e.g., if the liquidation were complete).[3] If no change to the indexing were made, the deferral may automatically become indexed to a smaller number of remaining, presumably illiquid assets. Instead, the manager may desire to elect, with the fund's consent, to have the portion of its deferred fees that would otherwise have been paid to it had the manager been a shareholder of the fund indexed to treasury bills as and when shareholders are paid.

In addition, as payment is not considered late under Section 409A of the Code if it is paid by the end of the calendar year in which the elected distribution date occurs, a manager may agree with the fund to delay a 2017 scheduled payment date to later in 2017[4] in order to give the fund more time to liquidate positions or for other reasons.

Payment in Kind

A payment in kind may be a desirable approach for a fund where the manager either does not wish to liquidate substantial assets or is not able to monetize particular positions to pay the deferred fees out in cash. As a result, a payment in the form of shares of the fund may be necessary to satisfy the requirement that the fees be paid in a timely manner under Section 409A of the Code, in which case the

[3] If there were a "back-to-back arrangement" and a partner or employee of the manager left the management firm, payment of such person's share of the deferral also generally gets accelerated.

[4] For a manager who had elected to be paid its deferred fees in January 2018 (with the tax liability still owing for 2017), a delay could be agreed to with the fund to later in 2018.

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manager should consider whether a "qualified electing fund" election is available and, if so, desirable.[5] If the fund is part of a master-feeder structure (including a "mini-master" structure), where the master fund is treated as a partnership for U.S. tax purposes, the fund may be able to pay the manager some or all of its deferred fees in the form of an interest in the master fund. Given that the manager will be taxed on the full value of the fees due, if the master fund has unrealized appreciation in its assets at the time of the payment of the deferred fees, the manager would be taxed in the year(s) when the master fund realizes gains on those assets even if there has been no subsequent increase in the value of the master fund's assets. Managers who are in this situation may want to consider whether it would be feasible to make an election under Section 754 of the Code at the master fund level, which would avoid the manager's picking up additional tax in that situation.

Investor Relations

The partners and employees of the managers will be taxed on the payment of the deferred fees, which could exceed 50 percent of the deferred fees paid depending on where the individual is resident. However, managers should be prepared to answer investor inquiries regarding what they plan to do with the remainder of such amounts. Managers who had treated their deferred compensation as a way of aligning their interests in the fund with those of their investors may wish to continue doing so through investing such after-tax amounts in a parallel fund or, if applicable, receiving payment of a portion of the deferred fees in kind in the form of master fund interests (as described in "Payment in Kind" above). Moreover, each manager should consider whether the payment of the deferred fees and corresponding reduction in the offshore fund's gross assets (assuming incoming subscriptions do not offset such reduction) is something to address in an investor communication, e.g., a periodic investor letter.

Authored by Philippe Benedict, Shlomo C. Twerski and David S. Griffel.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[5] In most cases, an offshore hedge fund that is classified as a corporation for U.S. tax purposes will be considered a "passive foreign investment company" ("PFIC"). A taxable U.S. shareholder faces several adverse consequences as a result of holding shares of such a PFIC, some of which are ameliorated by making a "qualified electing fund" election.