

# Financial Institutions

## E-ALERT

October 10, 2008

### Deferred Compensation Provisions of the Emergency Economic Stabilization Act

Tucked in at the end of the Emergency Economic Stabilization Act enacted into law on October 3rd is a new Section 457A of the Internal Revenue Code of 1986, as amended, addressing the taxation of deferred compensation paid by U.S. or foreign partnerships (and other entities taxed as partnerships for U.S. tax purposes) and foreign corporations that are not subject to a comprehensive foreign income tax regime. Under this new provision, deferred compensation payable to U.S. taxpayers by such entities is taxable when it is no longer subject to a substantial risk of forfeiture (i.e., upon vesting) rather than upon payment. In addition, under circumstances where the amount of the deferred compensation is not determinable at the time of vesting, the compensation will be taxed when it is determinable but will be subject to an additional 20% income tax (on top of regular income tax) plus interest.

Although the new provision is generally intended to prevent the offshore deferral of management fees and performance/incentive fees by U.S. hedge fund managers, it could have broader application and apply to deferral arrangements of U.S. managers that work for foreign corporations not engaged in the fund business as well as to compensation arrangements for certain private equity, fund of fund and other money managers beyond the hedge fund context. The new provision applies to deferred amounts which are attributable to services performed after December 31, 2008. Amounts deferred on account of services performed before January 1, 2009 may continue to be deferred under existing arrangements but, in general, must be included in income on or before December 31, 2017.

#### Deferred Compensation Highlights

- Beginning January 1, 2009, deferred fee income from offshore hedge funds will be taxed upon vesting rather than upon payment.
- Deferrals for periods prior to January 1, 2009 are unaffected but in general the deferred amounts must be included in income no later than December 31, 2017.
- If the offshore fee income is not determinable upon vesting, amounts will be taxed when determinable with an additional 20% income tax plus interest.
- The new provisions do not affect the taxation of "carried interest" received as a partnership allocation by most private equity fund managers.

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## Summary of New Rules

The principal change to the taxation of offshore deferral amounts is that income tax is owed on such amounts upon vesting rather than upon payment of the compensation. Under the new provision, any compensation (the "Target Compensation") which is deferred under a "nonqualified deferred compensation plan" of a "nonqualified entity" will be included in gross income when there is no substantial risk of forfeiture of such compensation. The new rules provide that compensation is subject to a substantial risk of forfeiture only so long as a person's rights to such compensation are conditioned upon the future performance of substantial services.

If the Target Compensation is not determinable at the time it vests (for example, a performance fee calculated on a multi-year return which vests in installments during the multi-year period), it will be included in gross income when it becomes determinable but the applicable income tax imposed will be increased by 20% plus interest at the underpayment rate plus 1%, accruing from the date on which the compensation vests. However, Congress has left room for the exclusion from this penalty provision of certain types of deferred compensation that are determined solely on the basis of the amount of gain recognized on the disposition of an "investment asset", for example the sale of an illiquid "side pocket" investment by a hedge fund in which the performance fee is vested but cannot be calculated until the investment is sold. To the extent provided in regulations prescribed by the Secretary of the Treasury, such compensation will be treated as subject to a substantial risk of forfeiture until the date of disposition. An "investment asset" is a single asset (other than an investment fund or similar entity) (i) acquired directly by an investment fund or similar entity, (ii) with respect to which such entity does not (nor does any person related to such entity) participate in the active management (or if such asset is an interest in an entity, in the active management of the activities of such entity) and (iii) substantially all of any gain on the disposition of which (other than such deferred compensation) is allocated to investors in such entity.

A "nonqualified entity" includes (i) any foreign corporation unless substantially all of its income is (A) effectively connected with the conduct of a U.S. trade or business or (B) subject to a "comprehensive foreign income tax" and (ii) any U.S. or foreign partnership (or other entity taxed as a partnership for U.S. tax purposes) unless substantially all of its income is allocated to persons other than (x) foreign persons with income not subject to a comprehensive foreign income tax and (y) tax exempt organizations.

The determination of whether a foreign person is subject to a "comprehensive foreign income tax" is based on whether either (i) the person is eligible for the benefits of a "comprehensive income tax treaty" between the applicable foreign country and the U.S. or (ii) the person otherwise demonstrates to the Secretary that the country has a comprehensive income tax. In defining non-qualified entity, Congress has targeted entities that are taxed in jurisdictions where the entities are indifferent to the deferral of compensation, for example, offshore tax havens where the entities receive no benefit from an offsetting tax deduction when the compensation is paid and included in the recipient's income. However, until there is more guidance from the Treasury on the definition of a "comprehensive foreign income tax", it will be unclear whether the definition is meant to pick up jurisdictions beyond tax havens whose tax regimes, particularly in respect of deferred compensation, are not as rigorous as the U.S.

Section 457A states that a "nonqualified deferred compensation plan" will have the same meaning as it does under Section 409A; in general, this includes any legally binding right to receive compensation in a later year for services performed in an earlier year. However the new provision contains two exceptions to the 409A meaning of deferred compensation. First, there is a special short term deferral provision which extends the two and a half month short term deferral deadline under 409A to twelve months. Thus, if the deferred compensation is paid within 12 months following the end of the year in which it vests, it is not subject to the tax upon vesting rules of

Section 457A. Second, in an effort to avoid a gap for payments based on equity appreciation, deferred compensation includes compensation that is based on the appreciation value of the service recipient's equity, which suggests that stock appreciation rights (SARs) will be subject to Section 457A even if they are granted at fair market value and would otherwise be exempt from 409A. Other types of phantom equity awards, such as restricted stock units, are subject to both Sections 457A and 409A.

### **Who is Affected?**

The definition of "non-qualified entity" will pick-up the offshore entities of many hedge funds, private equity funds and fund of funds that are formed by fund managers for participation by their foreign and tax exempt investors. However, as mentioned above, the new rules will have the most significant impact on hedge funds that receive management fees and performance fees based on the annual appreciation on their investment portfolios at the end of each year. These funds have allowed managers that share in a portion of the management fee or performance fee to defer payment and taxation of their vested portion of those fees by keeping them in the offshore entities for extended periods of time. To take advantage of the offshore deferral going forward, these managers would have to agree to forfeit the vested amounts if they are no longer performing services.

In general, it does not appear that the new provision will have much impact on private equity fund managers since they generally use management fees to pay managers compensation on a current basis and their performance fee is a partnership allocation (i.e. carried interest) that is not affected by Section 457A. However, for those private equity fund sponsors that have structured their carried interest as a performance fee rather than a partnership allocation, for example captive funds of corporate general sponsors, they will be impacted to the same extent as hedge funds by the new provision.

Until the Treasury provides guidance, its difficult to know whether Section 457A will have application beyond the investment fund context. However, given the broad scope of the definition of nonqualified entity which might reach foreign corporations or U.S. or foreign partnerships or limited liability companies that are operating companies, Section 457A could impact the deferred compensation arrangements of U.S. managers of those companies both in respect of traditional deferred compensation and of certain equity rights. In such cases, these managers would be subject to more disadvantageous tax treatment on their deferred compensation than their U.S. counterparts who would not be taxed until the deferred amounts are paid or the equity is realized.

Fund of funds managers tend to have similar compensation schemes to those of the managers of the underlying funds in which they invest so managers of hedge fund of funds will likely see more impact from the new requirements than managers of private equity fund of funds.

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