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EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION, TAX TRANSACTIONS UPDATE

Limit on Deferred Compensation for Offshore Investment Funds

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On October 3, 2008, Congress passed and President Bush signed the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (the "Act") which dramatically limits the ability of certain non-US investment funds (e.g., hedge funds and private equity funds) to provide nonqualified deferred compensation to US taxpayers. As a result, such funds' existing deferred compensation arrangements will generally no longer be effective for deferring taxable income with respect to services performed by US taxpayers after December 31, 2008. This memorandum outlines these new limitations.

How does the Act change the deferred compensation rules for investment funds?

Many non-US investment funds permit their investment managers to defer their management fees and/or performance fees (with a corresponding deferred recognition of taxable income). The new rules require that nonqualified deferred compensation be includible in the US taxpayer's income at the time it becomes vested. (Under current rules, recognition would be deferred to the date of actual payment, subject to the requirements of tax code Section 409A and general principles of constructive receipt.)

Who is subject to the new rules?

The rules apply to deferred compensation provided to US taxpayers by corporations and partnerships that would not benefit from a US or foreign income tax deduction (referred to as "nonqualified entities"), as described below.

Which corporations are nonqualified entities subject to the new rules?

A foreign corporation will be a nonqualified entity unless substantially all of the corporation's income is taxed by the US as income from a US trade or business or is subject to a comprehensive foreign income tax. Only a foreign corporation (or an entity treated as a corporation for US tax purposes) can be a nonqualified entity. A foreign corporation will be treated as subject to a "comprehensive foreign income tax" only if either: (1) it is eligible for the benefits of a

comprehensive income tax treaty between a foreign country and the US, or (2) it demonstrates to the satisfaction of the IRS that the foreign country has such a tax. Shortly before the bill was passed, a senior IRS representative said that "how that demonstration is going to be done or what constitutes a foreign tax very much remains to be seen."

Such entities would generally include investment funds located in jurisdictions not subject to US or foreign income tax. For example, investment funds classified as corporations for US federal income tax purposes that are formed in jurisdictions such as the Cayman Islands or Bermuda would be nonqualified entities.

Which partnerships are nonqualified entities subject to the new rules?

A partnership will be a nonqualified entity if a substantial portion of its income is allocated to either foreign persons not subject to a comprehensive foreign income tax or to organizations exempt from US tax. The Act does not specify the standards to be applied in determining whether the portion of a partnership's income is "substantial." For example, a US partnership whose partners include pension trusts, educational endowments, foundations and foreign persons or entities that are not subject to comprehensive income tax in their country of residence would be a nonqualified entity if such partners' interest in the partnership is "substantial" (unless such entities hold their interest in the partnership through taxable "blocker" corporations).

How do the rules apply to a service provider receiving compensation from affiliated entities if some of the entities are subject to US tax and others are not?

The Act does not address the treatment of deferred compensation where some of the compensation to a service provider is paid by nonqualified entities and the remainder is paid by affiliated entities subject to US tax. However, the Report of the House of Representatives (the "House Report" accompanying the version of the bill that was introduced earlier this year in a version substantially similar to the version that was enacted) stated that the IRS should issue regulations providing for the aggregation of affiliated entities. The report provided the example of deferred compensation paid to an employee by an employer subject to US tax, where that employer is a subsidiary of a foreign parent, and a deduction for the compensation would be available to the subsidiary. The example concludes that the subsidiary should not be treated as a nonqualified entity because it is subject to the US timing rule for deduction of the compensation.

Which deferrals are subject to the Act?

The restrictions apply to nonqualified deferred compensation, which is compensation for services paid in a year after the year in which the service provider obtains a legally binding right to the compensation. However, the restrictions do not apply to

compensation paid within the 12-month period after the service recipient's taxable year in which vesting occurs.

An amount will be treated as vested when it is no longer subject to a substantial risk of forfeiture. The restrictions provide that amounts will be subject to a substantial risk of forfeiture only if they are contingent on the future performance of substantial services. This definition is narrower than the definition of "substantial risk of forfeiture" used for the tax treatment of restricted stock and for the deferred compensation restrictions under tax code Section 409A.

As a result of this narrower definition, some incentive compensation arrangements will be subject to the Act even though they would not be treated as nonqualified deferred compensation under other tax rules. Under the Act, for example, it appears that nonqualified deferred compensation may include a performance incentive payment where the amount vests based on overall performance of a fund over a multiyear performance period, even if it is paid shortly after the end of the performance period.

A typical carried interest structured as a "profits interest" in an entity classified as a partnership for US federal income tax purposes generally should not be subject to the Act.

What special exemptions to these rules are provided?

An exception is provided for "single asset investments." If the amount of compensation is determined solely by reference to gain recognized upon the sale of a single asset that is not actively managed by the entity that owns the asset (i.e., passive assets), the Act provides that income inclusion would not be required until disposition of the asset. This provision is only applicable to the extent provided in IRS regulations to be drafted.

Another exception applies to compensation that vests before the amount of the compensation is determinable. In such a case, the amount is not subject to tax at the time it vests. However, at the time the amount becomes determinable, the full amount of compensation will be taxed as ordinary income, and the amount will also be subject to a tax of 20 percent of the compensation plus interest from the time of vesting until the time of income recognition.

The House Report provides that an amount will not be treated as determinable if that amount varies depending on satisfaction of an objective condition. As an example of an arrangement under which the amount is not determinable, the report describes an arrangement under which no payment would be made if a certain threshold is not met, 100 percent would be paid if the threshold is achieved, and 200 percent would be paid if a higher threshold is achieved.

When are the new rules effective?

The restrictions apply to amounts attributable to services performed after December 31, 2008. However, the restrictions also provide that amounts attributable to services performed before January 1, 2009, will be subject to tax in the last taxable year before 2018 or, if later, the year in which vesting occurs.

Do the new rules eliminate the need to amend nonqualified deferred compensation arrangements by the end of 2008?

Not later than December 31, 2008, most nonqualified deferred compensation plans must be amended to satisfy the complex requirements imposed by Section 409A, which primarily affect the deadlines for making deferral elections and the timing and form of payment of deferred amounts. Failing either to have such plan amendments adopted by the end of 2008 or to operate a plan in accordance with the requirements of Section 409A and the plan documents can result in the imposition of significant penalties, including accelerated recognition of taxable income, a 20 percent tax (in addition to regular income taxes) and interest penalties. Accordingly, investment funds (and other employers) should review their deferred compensation plans and arrangements to ensure that they comply, or become compliant, with these requirements by the end of 2008. The recently passed Act provides no relief from the December 31, 2008, deadline for the adoption of the Section 409A amendments.

What should be done with respect to existing deferred compensation arrangements with nonqualified entities?

Because a US taxpayer will generally not be able to defer the recognition of taxable income from deferred compensation paid by a nonqualified entity for services performed after December 31, 2008, investment fund sponsors should consider restructuring such deferred compensation arrangements before the end of the year. Such restructuring may entail the use of a partnership vehicle in which the sponsor would receive incentive allocations or a "profits interest" (rather than incentive fees) similar to the arrangement typically used in domestic investment funds. Although such an arrangement does not provide the same deferral previously available from a deferred compensation arrangement, the sponsor generally does not recognize income with respect to allocations of unrealized appreciation until such appreciation is recognized by the fund, and under current law the character of such income (all or a portion of which might be capital gain) passes through to the sponsor.

If you have any questions regarding this topic, please contact any of the lawyers listed below or any other member of our Employee Benefits & Executive Compensation or Tax Transactions practices.

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