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# New Tax Rules Re Certain Investment Fund Managers' Deferred Compensation

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On Friday, October 3, 2008, President Bush signed the Emergency Economic Stabilization Act of 2008 (the "Act") into law. Section 801 of the Act added new Section 457A (Nonqualified Deferred Compensation from Tax Indifferent Parties) to the Internal Revenue Code (the "Code"). In general, new Code Section 457A provides that any compensation deferred under a nonqualified deferred compensation plan of a nonqualified entity shall be includible in gross income when there is no substantial risk of forfeiture of the right to receive such compensation. According to Alan Tawshunsky, deputy division counsel and deputy associate chief counsel (employee benefits) for the I.R.S. Office of Associate Chief Counsel (Tax-Exempt and Government Entities), this new rule is targeted at hedge funds and private equity funds, but is broad enough to affect other arrangements as well.[1]

**Executive Summary**

The new rules generally require fund managers who defer compensation earned from (1) almost all offshore funds organized as corporations, and (2) certain funds (domestic or foreign) organized as partnerships that are comprised primarily of persons who are not generally subject to U.S. federal income taxation (or, in the case of foreign persons, not subject to a comprehensive foreign income tax)to include such compensation in taxable income when such compensation is no longer subject to a substantial risk of forfeiture. One important provision in the new rules concerns the deferral by hedge fund managers of their "incentive fees."[2] Under the new rules, if the amount of the deferred incentive fee cannot be determined at the time it is supposed to be included in taxable income, then such deferred incentive fee shall be included when the amount can be determined but the recipient of such deferred incentive fee will be subject to an interest charge and a 20% penalty. The new rules apply to deferred compensation attributable to services performed after December 31, 2008. Fund managers who currently have deferred compensation arrangements with their funds should consult their tax advisors regarding the applicability of these new rules to their plans in 2009 and future years.

**Discussion**

Since early 2007, Congress has placed greater focus on the fee and compensation arrangements entered into between hedge and private equity funds and their managers, including fee deferrals by U.S. managers of offshore investment funds. As a result of this focus, Congress recently enacted Code Section 457A, which could have a significant impact on the federal income tax treatment of deferred fund manager compensation.[3] Under Code Section 457A, any compensation deferred under a "nonqualified deferred compensation plan" of a "nonqualified entity" is includible as gross income when there is no substantial risk of forfeiture of the right to receive such compensation.

**Nonqualified Deferred Compensation Plans**

A "nonqualified deferred compensation plan" is broadly defined under Code Section 457A to include most plans that provide for the deferral of compensation (except certain qualified employer plans and bona fide vacation, sick, disability or death benefit plans). In general, the definition of a "nonqualified deferred compensation plan" is the same under new Code Section 457A as it is under Code Section 409A,[4] except that under Code Section 457A, a nonqualified deferred compensation plan also includes any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient. For purposes of new Code Section 457A, compensation is treated as deferred if the service provider receives payment more than 12 months after the end of the taxable year of the service recipient during which the right to the payment of such compensation is no longer subject to a substantial risk of forfeiture.

**Nonqualified Entities**

Under Code Section 457A, a "nonqualified entity" is (1) a foreign corporation, unless substantially all of its income is (a) effectively connected with the conduct of a trade or business in the U.S. or (b) subject to a comprehensive foreign income tax, or (2) any partnership, unless substantially all of its income is allocated to persons other than tax-exempt persons and foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax. Neither the statute nor the legislative history provides any guidance regarding the meaning of "substantially all." However, it would appear that almost all offshore hedge funds (which are typically organized as foreign corporations with no income that is effectively connected with a U.S. trade or business) would be treated as nonqualified entities under Code Section 457A. Accordingly, the managers of such funds who defer their compensation from such funds would be subject to new Code Section 457A.

In addition, certain domestic and offshore private equity funds (which are typically organized as partnerships) could be treated as nonqualified entities under Code Section 457A if structured such that their investors are not substantially all persons other than tax-exempt persons and foreign persons whose income is not subject to a comprehensive foreign income tax. Of course, funds structured as partnerships do not typically establish these types of deferred compensation arrangements.

**Substantial Risk of Forfeiture**

For Code Section 457A purposes, a person's right to compensation is subject to a substantial risk of forfeiture only if such right is conditioned upon future performance of substantial services by any individual. The term "substantial risk of forfeiture" is used and defined in several places in the Code. Moreover, new Code Section 457A does not elaborate on what constitutes a substantial risk of forfeiture. For example, there is no guidance under Code Section 457A regarding what minimum amount of future services must be performed in order to qualify as substantial risk for these purposes. However, the language used in new Code Section 457A regarding substantial risk of forfeiture is substantially similar to that used in Code Section 83(c), which deals with the taxation of property transferred in connection with the performance of services.[5] Because of the similarity in the definition of "substantial risk of forfeiture" under Code Sections 457A and 83, it seems reasonable to look to the Treasury regulations under Code Section 83 for guidance here.

**Penalty Provisions**

One important provision in new Code Section 457A is a special rule regarding deferred compensation subject to Code Section 457A the amount of which is indeterminable at the time the service recipient is required to include it in gross taxable income. If the amount of the deferred compensation cannot be determined at the time it is supposed to be included in taxable income, then such compensation shall be included in taxable income when the amount can be determined but the recipient of such compensation will be subject to an interest charge and a 20% penalty. This harsh penalty provision is substantially similar to the penalty provisions of Code Section 409A.

However, for U.S. fund managers who defer receipt of their management fees and find that their deferred compensation is subject to Code Section 457A, the penalty provision in Code Section 457A will likely not apply because the management fee is typically a percentage of the fund's assets under management, and, therefore, the amount deferred should be determinable.

For deferred compensation that is no longer subject to a substantial risk of forfeiture, there appears to be only one method of delaying taxation without being subjected to the harsh penalty provisions described above. To the extent provided by Treasury regulations, if compensation is determined solely by reference to the amount of gain recognized on the disposition of an "investment asset," such compensation shall be treated as subject to a substantial risk of forfeiture until the date of such disposition. However, it should be noted that an "investment asset" is defined quite narrowly for these purposes as any single asset acquired directly by an investment fund or similar entity, with respect to which such entity (or any related person) does not participate in the active management of such asset, and substantially all of the gain on the disposition of which (other than such deferred compensation) is allocated to investors in such entity. In addition, the extent and applicability of this exception is subject to Treasury regulations which have not yet been issued.

**“Carried Interests” and “Incentive Fees”**

An important interpretive issue is what constitutes “compensation” for purposes of Code Section 457A. Managers of offshore hedge funds generally receive, among other items, an incentive fee from the fund. In general, incentive fees from offshore hedge funds are calculated as a percentage of the aggregate appreciation or gain in the hedge funds’ investments. Economically, incentive fees are substantially similar to a private equity fund’s carried interest; however, unlike carried interests, incentive fees do not constitute interests in partnership profits. Rather, the incentive fees result from a contractual agreement between the fund manager and the offshore hedge fund, which is a corporation for U.S. tax purposes. Thus, the incentive fees would likely be viewed as compensation, the deferral of which would be subject to new Code Section 457A.

It is unclear how to apply the exception for compensation determined solely by reference to the amount of gain recognized on the disposition of an investment asset. At first glance, this exception could be viewed as meaning that the deferral of any incentive fees would be subject to a substantial risk of forfeiture until the date such incentive fees are realized; yet because incentive fees are typically calculated by reference to the fund’s aggregate profit (as opposed to by reference to any single fund asset), it is unclear whether such incentive fees would be deemed to constitute compensation determined *solely* by reference to the gain on the sale of an investment asset.

In contrast to hedge fund managers, many managers of private equity funds organized as partnerships for federal income tax purposes take the position that their “carried interest” constitutes an interest in partnership profits rather than compensation for federal income tax purposes. Under this view, deferring receipt of the carried interest should not be subject to new Code Section 457A. [6] If the deferral of the carried interest was considered to be deferred compensation for purposes of new Code Section 457A, then, as discussed above with respect to incentive fees, it would be unclear how to apply the exception for compensation determined solely by reference to the amount of gain recognized on the disposition of an investment asset.

**Effective Date and Future Guidance**

New Code Section 457A applies to amounts deferred which are attributable to services performed after December 31, 2008. For current deferred compensation arrangements, if the deferred compensation is not includible in taxable income until 2018 or later, such amount will be includible in taxable income in the later of (1) the last taxable year beginning before 2018, or (2) the taxable year in which there is no substantial risk of forfeiture. In addition, no later than 120 days after the date of enactment, the Treasury Secretary shall issue guidance providing a limited period of time during which current nonqualified deferred compensation arrangements may be amended, without violating Code Section 409A, so that their distribution dates match the dates such amounts are required to be included in taxable income under new Code Section 457A.

[1] Sam Young, I.R.S. Official Explains Executive Compensation Offset in Bailout, Extenders Bill, 2008 TNT 194-4 (Oct. 6, 2008).

[2] As discussed below, incentive fees are generally calculated as a percentage of the aggregate appreciation or gain in the hedge funds’ investments.

[3] Although new Code Section 457A only recently became law, it was originally proposed as part of the AMT Relief Act of 2007, H.R. 4351, 110th Cong. (2007), and again as part of the Energy and Tax Extenders Act of 2008, H.R. 6049, 110th Cong. (2008).

[4] Code Section 409A was enacted in 2004 and generally governs the taxation of nonqualified deferred compensation plans. It provides rules for when compensation from nonqualified deferred compensation plans must be included in the recipient’s taxable income.

[5] Mr. Tawshunsky notes that the I.R.S. is using the Code Section 83 definition of "substantial risk of forfeiture." *See* Sam Young, I.R.S. Official Explains Executive Compensation Offset in Bailout, Extenders Bill, 2008 TNT 194-4 (Oct. 6, 2008).

[6] As noted above, in general, the definition of a "nonqualified deferred compensation plan" is the same under new Code Section 457A as it is under Code Section 409A. Currently, under I.R.S. Notice 2005-1, C.B. 274, Q&A 7, until additional guidance is issued, for purposes of Code Section 409A, taxpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated under applicable guidance as not resulting in inclusion of income by the service provider at the time of issuance, as also not resulting in the deferral of compensation.

In addition, many fund managers who waive their management fees in exchange for a larger share of the fund's future profits also rely on I.R.S. Notice 2005-1 to take the position that the larger share of fund profits received in exchange for their waived management fees is not subject to Code Section 409A.