DrinkerBiddle

Hedge Fund Alert
January 26, 2009

New IRS Guidance Discusses Restrictions on Deferred Compensation Payable by Certain Offshore Funds

New section 457A of the Internal Revenue Code became effective January 1, 2009, and generally provides that amounts deferred under a nonqualified deferred compensation plan sponsored by certain offshore funds and other "nonqualified entities"[1] is included in the service provider's taxable income when the deferred compensation is no longer subject to a "substantial risk of forfeiture," whether or not it is payable to the service provider at that time.

The Internal Revenue Service issued guidance under this section this month in the form of Notice 2009-8 (the Notice). The IRS clarifies the following matters in its guidance:

> "Substantial risk of forfeiture" is defined more narrowly for offshore funds than it is for deferred compensation payable to service providers by domestic entities under section 409A of the Internal Revenue Code. Under new section 457A, a substantial risk of forfeiture exists only if the service provider's rights to the deferred compensation are conditioned on the future performance of substantial services by the service provider. The guidance indicates that the service provider for this purpose need not be an individual, but can be the investment adviser to the fund, for example.

> If deferred compensation is not subject to a substantial risk of forfeiture, but the amount of the deferred compensation is not determinable, then the deferred compensation will not be taxed to the service provider until the amount is determinable. However, the amount will then be subject to a 20 percent additional tax and interest on the late payment of taxes at a percentage point above the normal rate.

[1] An offshore fund that is organized as a corporation is generally a nonqualified entity unless substantially all of its income is (i) effectively connected with the conduct of a trade or business in the United States or (ii) subject to a comprehensive foreign income tax. A fund organized as a partnership (whether a U.S. or a non-U.S. partnership) is generally a nonqualified entity unless substantially all of its income is allocated to persons other than (i) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax and (ii) tax-exempt organizations.

For example, if an investment adviser is entitled to incentive fees for 2009-2011, based on the performance of the fund over that three-year period, payable in January 2012 (or earlier, with payout based on performance to date, if the investment adviser resigns before the end of the three-year period), then the investment adviser will not be taxed on the deferred compensation until 2011 (even though the deferred compensation is not subject to a substantial risk of forfeiture in 2009), because the amount of the deferred compensation is not determinable until December 31, 2011. However, the amount of the incentive fees will be included in the investment adviser's taxable income for 2011 (even though they are not paid until January 2012) and an additional 20 percent tax will be imposed on the amount. Further, the fees will be treated as having been payable in 2009 and therefore interest on the late payment of taxes will also be imposed and at a rate that is one percentage point above the normal late-payment rate.

- Unlike section 409A, equity appreciation rights are subject to section 457A (unless they can be settled only in service recipient equity, not in cash).
- Despite the general rule that vested deferred compensation cannot be deferred under section 457A, the service provider and the service recipient may agree to a "short-term deferral" that requires the payment of the deferred compensation not later than 12 months after the end of the service recipient's taxable year in which the deferred compensation becomes vested (*i.e.*, is no longer subject to a substantial risk of forfeiture).
- Amounts deferred before 2009 that are no longer subject to a substantial risk of forfeiture must be included in income in a taxable year beginning before 2018. For such amounts, the time and form of payment of the amount may be changed to conform the date of distribution to the date the amount may be required to be included in income under section 457A, provided the change is *in writing and adopted not later than December 31, 2011*.
- If any compensation deferred before 2009 remains subject to a substantial risk of forfeiture, the service provider and service recipient may amend the arrangement to eliminate the substantial risk of forfeiture retroactively to a date before 2009, as long as the amendment is *in writing and is adopted before July 1, 2009*. The result of such an amendment is that the deferred amount may be included in the service provider's taxable income as late as 2017, rather than on the date on which the substantial risk of forfeiture would otherwise have lapsed.

The Notice is complex, filled with additional details and contains numerous examples. We would be happy to discuss the Notice with you in greater detail.

Investment Management Group

For more information about the matters discussed in this alert, please contact your regular Drinker Biddle lawyer or any member of our Investment Management Group.

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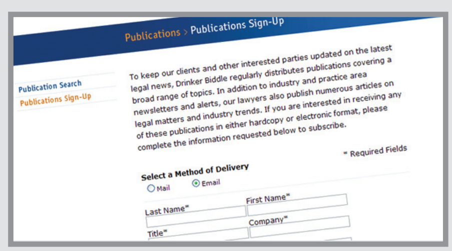

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