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A legal update from Dechert's International and Domestic Tax and Employee Benefits and Executive Compensation Groups

New Tax Rules Affect Deferred Fees Earned by Hedge Fund and Private Equity Fund Managers

The Emergency Economic Stabilization Act of 2008 (the "Act"), as signed into law on October 3, 2008, contains several changes to the tax code that fundamentally restrict the ability of certain hedge fund and private equity fund managers to defer the recognition of taxable income using certain deferred compensation arrangements. The new provisions directly affect the manager's decision to defer for several years receipt of performance fees and/or management fees otherwise due, even if measured by appreciation in value of the fund. Prior to this change in law, a fund manager could defer taxation attributable to management and incentive fees until those amounts were paid to the manager by the offshore entity, with the ultimate payout being increased by the appreciation in the value of an investment in the fund over the period of deferral. Such arrangements, in effect, allowed deferred fees to be reinvested back into the fund on a pre-tax basis. These plans have been put into place almost exclusively in the context of offshore funds where the corresponding deferral of the compensation deduction by the fund is without tax significance to either the fund or its investors.

The Act changes this regime by taxing certain currently deferred compensation arrangements of "Nonqualified Entities." A "Nonqualified Entity" generally includes (a) any foreign corporation that is not subject either to U.S. tax or to a comprehensive foreign income tax and (b) any partnership unless substantially all of the partnership's income is allocated to taxable investors (including foreign persons who are subject to a comprehensive foreign income tax). Any such compensation ostensibly deferred by a fund manager under a plan of a Nonqualified Entity will be taxed when that compensation is no longer subject to a substantial risk of forfeiture. Under the Act, a substantial risk of forfeiture exists only if the manager's right to receive the compensation is conditioned on the future performance of substantial services.

Some shorter-term deferrals will not be affected by the Act because any compensation that is distributed to a fund manager within 12 months after the end of the taxable year in which such amount becomes vested is not treated as deferred. However, most deferrals of the payment of vested compensation by Nonqualified Entities will no longer result in a deferral of tax for the recipient even if the deferred amounts remain subject to the claims of fund creditors.

Notwithstanding the foregoing, vested deferred compensation payable by a Nonqualified Entity will not be subject to tax in the year of vesting if the amount is "not determinable" in the year of grant. This exception comes with a stiff toll

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charge, however, as not only will the deferral be subject to taxation once the amount becomes determinable, but interest on the deferred amount for the period of deferral and a penalty tax equal to 20% of the total amount deferred will also be imposed at that time.

It is worth noting that the Act does not address the typical carried interest situation. Thus, for hedge funds and private equity funds that are formed as partnerships and that provide incentives to fund managers in the form of carried interests, such arrangements should not be treated as deferred compensation subject to the Act's new anti-deferral rule. In any event, such funds generally would not fall within the definition of Nonqualified Entity because substantially all the investors in those funds generally would be subject to income tax.

The Act's effective prohibition on deferrals generally applies to compensation for services rendered after December 31, 2008. Existing deferrals attributable to services performed prior to January 1, 2009 are grandfathered under the Act, provided any such amounts deferred are distributed and taxed before the last taxable year beginning prior to 2018 (or when such compensation becomes vested, if later). The Act also promises future guidance to permit plans to conform to these new rules without otherwise violating the existing deferred compensation rules under Section 409A of the Code.

The application of the Act to deferred compensation is highly technical. We recommend undertaking with tax counsel a review of current deferred compensation arrangements that may fall within the scope of these provisions and consideration of potential alternative approaches to compensation arrangements.

Practice group contacts

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