

Client Alert

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Proposed Deferred Compensation Regulations Affect Hedge Fund Deferral Arrangements

On September 29, 2005, the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") issued proposed regulations on the new deferred compensation rules under Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"). The proposed regulations and the IRS's prior deferred compensation guidance, Notice 2005-1 (the "IRS Notice"), are available on the Treasury Department's website at www.treas.gov.

Code Section 409A ("Section 409A") was added by the American Jobs Creation Act of 2004 (the "Act") in response to perceived abuses with respect to certain nonqualified deferred compensation arrangements. Section 409A significantly altered the rules applicable to nonqualified deferred compensation and impacts "traditional" nonqualified deferred compensation arrangements, as well as many other arrangements such as certain fee deferral arrangements between investment managers and hedge funds.

This Client Alert focuses in particular on the effect of the proposed regulations on deferral arrangements between investment managers and hedge funds. For a more general discussion of the proposed regulations, please refer to our recent Client Alert "Update On New Deferred Compensation Rules: Proposed Regulations Issued Under Code Section 409A." For a summary of the provisions of Section 409A and Notice 2005-1, please refer to our previous Client Alerts entitled, "Recent Legislation Impacts Deferred Compensation and More" and "Treasury and IRS

Issue Guidance on Nonqualified Deferred Compensation." All of these Client Alerts are available on our website at www.proskauer.com/news_publications/client_alerts/index.

Applicability to Arrangements between Investment Managers and Hedge Funds

Although many provisions of Section 409A contemplate deferred compensation arrangements between employers and employees, the initial IRS guidance was clear that Section 409A also extended to deferred compensation received by "service providers" such as personal service corporations and similar entities. The IRS Notice, however, provides a general exemption from application of Section 409A to certain service providers that have multiple unrelated clients. It was unclear under the IRS Notice whether the exemption for such service providers could apply to hedge fund managers. The proposed regulations expand the definition of "service provider," and further defines what it means for clients to be "unrelated," in each case more clearly confirming that most deferral arrangements between investment managers and hedge funds will be subject to Section 409A.

Treatment of Back-to-Back Deferral Arrangements Clarified

One significant open issue that the IRS had not addressed before issuing the proposed regulations was the effect of Section 409A on "back-to-back" deferral arrangements, wherein entities such as hedge funds and their investment managers have fee deferral arrangements that parallel deferred compensation arrangements with the manager's employees. Previously, it was unclear whether these arrangements were permitted to pay deferred fees payable to the investment manager at the time deferred compensation became payable to the investment manager's employee, such as upon the employee's separation from service.

The proposed regulations permit back-to-back deferral arrangements in this context if (i) the deferred compensation arrangement between the investment manager and the employee is subject to and complies with Section 409A, and (ii) the deferred compensation arrangement between the hedge fund and the investment manager expressly provides for payment to the investment manager at the time and in the form payment is made to the employee provided such payment is made upon the employee's separation from service, disability, death, unforeseeable emergency, upon the investment manager's change in ownership, or at a specified time or pursuant to a fixed schedule. Furthermore, the arrangement between the fund and the investment manager must otherwise satisfy Section 409A.

Hedge Funds with Non-Calendar Year Fiscal Years

An election to defer compensation must generally be made no later than December 31 of the calendar year preceding the year in which the services are rendered. However, a special rule applicable to "fiscal year compensation" may apply where a hedge fund uses a fiscal year other than the calendar year. In this case, the investment manager's deferral election with respect to compensation that is based on the hedge fund's fiscal year has to be made before the end of the hedge fund's fiscal year that most recently precedes the fiscal year with respect to which the compensation is payable.

Still, this special rule is applicable only to the extent that the fiscal year compensation is otherwise payable after the end of the applicable fiscal year. For example, most fiscal year-based performance fees, to the extent not covered under the special rule described in the next section below, would be subject to this special rule. Compensation that is based on the fund's fiscal year, but paid within that fiscal year (for example, a management fee that is paid quarterly during the fiscal year or a performance fee paid mid-year on an investor's exit from the fund), is subject to the ordinary deferral rules. That is, for compensation paid during the fiscal year, an investment manager using the calendar year would still have to make a deferral election before the December 31 that precedes the beginning of the hedge fund's fiscal year.

Initial Deferral Elections for Performance-Based Compensation

As noted above, an election to defer compensation must generally be made no later than December 31 of the calendar year preceding the year in which the services are rendered. However, another special rule provides that in the case of any compensation that is considered "performance-based compensation" based on services performed over a period of at least twelve months an investment manager's initial deferral election may be made as late as six months before the end of the performance period. The proposed

regulations generally define performance-based compensation as compensation contingent on the satisfaction of pre-established organizational or individual performance criteria. Also, the proposed regulations depart from the IRS Notice in providing that performance-based compensation may include amounts that are based solely on the value of, or appreciation in value of, the service recipient. However, it is unclear whether a fund manager could delay a deferral election under the investment manager's plan solely because the incentive compensation is based on the performance of a hedge fund to which the manager provides services.

Permissible Payment Date for Annual Bonuses or Performance Fees

It is a fairly common practice for hedge funds and other employers to pay annual bonuses or performance fees as soon as reasonably practicable following the receipt of audited financial statements, in order to allow sufficient time to determine if annual performance hurdles have been achieved. Under the IRS Notice, it was unclear whether such an arrangement met Section 409A's rules regarding permissible payment dates. (For this reason, many practitioners advised that annual bonuses or performance fees should be paid out within 2½ months of the end of the year with respect to which they were payable, thus avoiding the applicability of Section 409A entirely through the "short-term deferral" exemption.)

However, the proposed regulations now clarify that the Act's requirements with respect to permissible payment dates are satisfied so long as the calendar year in which the deferred amount is payable is clearly specified under the arrangement when the amount is deferred. Thus, for example, it would be permissible for an investment management agreement to specify that payment of the manager's performance fee with respect to the 2006 year could occur anytime in 2007.

Treatment of Offshore Arrangements and Arrangements Maintained by Partnerships Remain Unclear

In addition to its rules regarding when compensation may be deferred and received, Section 409A also prohibits deferred compensation arrangements to be funded through offshore trusts or other arrangements determined by the Treasury. Many have noted that the language of the statute, although it does not appear to be intended to apply to the typical deferred fee arrangement, is potentially broad enough to include deferral arrangements with offshore hedge funds.

Unfortunately, the proposed regulations leave open what constitutes a prohibited offshore arrangement. Presumably, in including relief for back-to-back deferral arrangements, the IRS recognized that these arrangements most typically

are entered into with offshore hedge funds. Further IRS guidance is expected to clarify this issue.

Future guidance also is expected to clarify the application of Section 409A to deferred compensation arrangements between partnerships and their partners, which may affect the arrangements between investment managers and their equity owners.

Effective Dates

Section 409A generally is effective for amounts deferred after December 31, 2004; it is generally not applicable for deferred amounts that were earned and vested on or before that date unless the deferral arrangement has been materially modified after October 3, 2004. Thus, changes in pre-December 31, 2004 deferrals, such as amendments to permit a change to the deferral period, will subject these amounts to Section 409A.

Compliance Deadlines

The proposed regulations are scheduled to become effective for taxable years beginning on or after January 1, 2007 and plans adopted before this date must be amended on or before December 31, 2006, either to conform to the requirements of Section 409A or to provide for compensation that is exempt from Section 409A.

Regardless of when the formal plan document establishing the deferral arrangement is amended, plans subject to Section 409A must continue to be operated in accordance with the provisions of Section 409A. Good faith compliance with Section 409A, the proposed regulations and Notice 2005-1 will suffice for this purpose.

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Client Alert

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