Paul|Weiss

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New Code Section 457A:

- Offshore Deferred Compensation Taxed When Earned, Not When Paid
- Side Pocket Exception May Not Work
- MPI Unaffected
- Year End Effective Date – Prompt Review Needed
- Unexpected Impact on Operating Partnerships and PE Funds?

New Internal Revenue Code Section 457A was added by the Emergency Economic Stabilization Act, enacted on October 3. The new rules render ineffective many nonqualified deferred compensation plans, including those often used by managers of offshore hedge funds to defer taxes on management incentive fees.

Overview – Who's Affected?

Section 457A applies to deferred compensation arrangements of certain foreign corporations that have little income taxable in the U.S. and are not subject to a comprehensive foreign income tax. The new rules also apply to partnerships (domestic or foreign) with meaningful participation by investors who are not subject to U.S. income tax (including U.S. private and public pension plans) or to a comprehensive foreign income tax.

The typical offshore hedge fund, and many U.S. private equity funds, will be treated as "nonqualified employers" and so may be subject to the new Section 457A rules. Private equity funds rarely provide deferred compensation to managers, but offshore hedge funds do, and many of those offshore hedge funds will be directly affected by the new rules.

Overview – Summary of Section 457A

Broadly speaking, under Section 457A:

- Nonqualified deferred compensation (elective or non-elective) provided by a nonqualified employer will be taxed when the right to receive payment vests, rather than when paid.

1285 Avenue of the Americas
New York, New York 10019-6064
(212) 373-3000

1615 L Street, NW
Washington, DC 20036-5694
(202) 223-7300

Alder Castle, 10 Noble Street
London EC2V 7JU England
(44-20) 7367 1600

Fukoku Seimei Building 2nd Floor
2-2, Uchisawaicho 2-chome
Chiyoda-ku, Tokyo 100-001, Japan
(81-3) 3597-8101

Unit 3601, Fortune Plaza Office Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
(86-10) 5828-6300

12th Fl., Hong Kong Club Building
3A Chater Road, Central
Hong Kong
(852) 2536-9933

- Section 457A generally *prevents* the deferral of compensation, by taxing income when it vests rather than when paid; however, in certain circumstances, Section 457A *penalizes* deferred compensation, by allowing deferred recognition of income but imposing penalty taxes on the ultimate payment. In contrast, the much-discussed Code Section 409A generally *regulates* deferred compensation, by allowing a deferral of tax until payment is made, but only for properly structured arrangements.
- Under Section 457A, the right to payment of compensation vests when the right to receive the payment is no longer conditioned on the future performance of substantial services, *even if substantial performance-based vesting conditions continue to apply*. This is in contrast to tax principles contained elsewhere in the Code, including those applicable to compensatory property transfers and deferred compensation.

- If the amount of compensation is not determinable when it becomes taxable (as would be the case, for example, for incentive payments with respect to certain side pocket investments), it is taxed when it becomes determinable, but is subject to substantial penalties on the payment date, including:
  - a 20% penalty tax on the amount of compensation; and
  - interest at the underpayment rate plus 1%, applied to the amount of tax that would have been incurred when the compensation originally vested (calculated on the amount of compensation ultimately determined and paid).
- Section 457A includes a special exception (to be implemented by regulations) for compensation that is determined solely by reference to the amount of gain recognized on the disposition of a passive investment in a single asset.
  - Such compensation is taxable (without penalties) upon the ultimate disposition of the asset, even if the right to receive payment vested earlier.
  - This exception would seem to be aimed at allowing deferral of taxation (without penalties) until realization of hedge fund side pocket investments. However, because of the "single asset" requirement, the exception may not be available in many cases, because hedge funds often aggregate the results of a side pocket realization with other investment results when determining incentive fee amounts.

Overview – Plans Affected

- Section 457A and Section 409A generally address the same kinds of deferred payment arrangements, but there are some important differences.
- Section 457A applies to stock and other equity appreciation rights, whether or not subject to Section 409A. From this, it appears that Section 457A can apply to

phantom equity and some deal bonus plans of affected employers. In contrast, Section 409A generally does not apply to equity appreciation rights (whether electively exercised or settled automatically), if the equity appreciation right payment is based only on appreciation over grant date fair value of the underlying equity.

- Another variance from Section 409A: Section 409A does not apply where deferred compensation is paid out within 2-1/2 months after the end of the year in which it vests. Section 457A does not apply if compensation is paid out within 12 months after the end of the year in which *service-related vesting conditions* are satisfied.

Fee Waiver, MPI and "Mini-Master" Arrangements

The Section 457A rules apply to deferred compensation and do not reach the typical carried interest arrangements by which private equity fund managers are compensated, nor should they reach fee waiver arrangements that are structured as partnership interests (often called "Fee Waiver Interests," "Management Profits Interests" or "MPI").

In addition, Section 457A should not apply to allocations of income from hedge funds that use a mini-master structure, which is akin to carried interest in private equity funds.

Unexpected Impact on Operating Partnerships and Private Equity Funds?

Section 457A seems largely aimed at blocking deferred compensation plans for managers of offshore hedge funds. However, as written Section 457A could apply to operating partnerships that maintain deferred compensation plans or phantom equity plans for managers of the operating business, even if all operations are conducted in the U.S. This might occur, for example, where more than an insubstantial amount of partnership income is allocated to U.S. state government pension plans. Such an arrangement would not be uncommon, as where an operating business is conducted through a partnership in which one or more private equity funds has invested (and where state pension plans are part of the investing group). Thus, as written, Section 457A could affect some deal bonus plans for management of an operating business, unless the plan requires continued employment through the transaction closing.

Effective Dates

- Future Compensation. The new rules apply to amounts deferred which are attributable to services performed after December 31, 2008.

- Past Compensation. In order to avoid penalty taxes, amounts attributable to services before 2009 must generally be brought into income before 2018.

- Transition Rules. The Treasury is required to issue rules by January 31, 2009 allowing changes to be made to existing arrangements so as to permit compliance with the new Section 457A rules without running afoul of Section 409A prohibitions. Also, the Treasury is to provide guidance for back-to-back

arrangements—for example, where employees of the fund manager have elected to defer compensation which will be funded out of deferrals that the manager itself will be making against a fund that is subject to Section 457A.

What Should You Do Now?

With or without Section 457A, employers should review all of their deferred compensation arrangements because December 31, 2008 is the final date for complying with Code Section 409A, the deferred compensation law that regulates elective and non-elective deferred compensation, whether onshore or offshore.

Employers potentially subject to Section 457A should review their compensation arrangements and, if need be, their corporate or organizational structures soon, so as to quickly identify arrangements that will be affected by Section 457A and consider what adjustments may be necessary or desirable in light of the new law.

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This alert is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content.

If you have any questions concerning this alert, please contact:

Benefits/Executive Compensation:

Robert C. Fleder	212-373-3107	rfleder@paulweiss.com
Lawrence I. Witdorchic	212-373-3237	lwitdorchic@paulweiss.com

Tax:

David W. Mayo	212-373-3324	dmayo@paulweiss.com
David R. Sicular	212-373-3082	dsicular@paulweiss.com
Peter J. Rothenberg	212-373-3154	prothenberg@paulweiss.com

Investment Funds:

Robert M. Hirsh	212-373-3108	rhirsh@paulweiss.com
Marco V. Masotti	212-373-3034	mmasotti@paulweiss.com