

New Law Effectively Ends Most Offshore Hedge Fund Fee Deferrals

The recently enacted Emergency Economic Stabilization Act of 2008 includes a new section (Section 457A) of the Internal Revenue Code that effectively puts an end to most ongoing offshore hedge fund fee deferral programs. Under Section 457A, U.S. investment managers of offshore investment funds will generally no longer be entitled to defer compensation for services performed after December 31, 2008.

Section 457A is aimed at eliminating deferrals from tax-haven jurisdictions. Section 457A generally requires an investment manager and other service providers to include in income all compensation payable by a nonqualified foreign entity pursuant to a nonqualified deferred compensation plan at the time that entitlement to such compensation is not subject to a substantial risk of forfeiture. Nonqualified foreign entities include foreign corporations unless substantially all of their income is subject to U.S. federal income tax and foreign partnerships unless substantially all of their income is allocated to persons who are U.S. taxable investors or foreign persons with respect to whom the income is subject to a comprehensive foreign income tax. Offshore investment funds will be treated as nonqualified foreign entities (because their income is not generally subject to U.S. tax) and investment managers will not be entitled to defer the compensation payable by offshore investment funds.

Although the legislation contains some exceptions to this general rule, including one for payments received not later than 12 months after the end of the taxable year in which the right to payment vests, Section 457A in most cases will prevent the types of fee deferrals that have been common in many, if not most, hedge fund investment management arrangements involving offshore funds.

Section 457A applies to income earned for services performed after December 31, 2008. Under a limited transition rule, any deferred compensation attributable to services performed prior to January 1, 2009 that would have been covered by the legislation if performed after December 31, 2008 must be included in the service provider's income by the later of the last taxable year beginning before 2018 or the taxable year in which there is not a substantial risk of forfeiture to the right to such compensation. In most situations, this transition rule will permit the continuing deferral of amounts attributable to services performed prior to January 1, 2009 under existing deferred compensation plans until no later than December 31, 2017. Section 457A also directs the U.S. Department of Treasury to issue transition relief to allow taxpayers to modify their deferral plans (and related back-to-back deferred compensation arrangements with employees of the investment manager) to comply with Section 457A without violating Section 409A.

In light of this repeal of deferred compensation for investment managers of offshore investment funds, it may be prudent for fund managers to consider before year-end certain planning techniques to maximize any advantage of the transition relief provided in Section 457A and to address the challenges posed by Section 457A in compensation arrangements going forward.

If you would like to discuss any aspect of this alert or require further information on the matters referred to, please contact [Sarah Downie](#) or [Clayton Reynolds](#) in New York, or [Jim Waddington](#) in London.