

**NEW TAX ON NONQUALIFIED DEFERRED COMPENSATION
FROM CERTAIN TAX-INDIFFERENT PARTIES**

The Emergency Economic Stabilization Act of 2008 (the “Act”), which was passed this afternoon and is expected to be signed by the President imminently, adds new Section 457A to the Internal Revenue Code of 1986, as amended (the “Code”). This new section is intended to prevent taxpayers from deferring compensation (other than under a qualified plan) if the deferral results in no offsetting tax detriment to the person paying the compensation by reason of its tax status and the tax treatment of its income.

Highlights

Section 457A is particularly relevant to money managers. Highlights include:

- Starting in 2009, money managers will generally no longer be permitted to defer fees from their offshore funds (and certain other tax-indifferent service recipients).
- Fee deferrals for services through 2008 generally are not required to be included in income until 2017.
- Many fee arrangements on “side pockets” in offshore funds (and certain other tax-indifferent service recipients) will need to be restructured to avoid a 20% penalty and interest charge.
- Certain other fee arrangements with offshore funds (and certain other tax-indifferent service recipients) covering more than one year may also need to be changed to avoid a 20% penalty and interest charge. For example, incentive fees based on a three-year period would be subject to these charges unless paid each year (perhaps subject to a clawback) or made forfeitable upon a termination of service prior to year three.
- Traditionally, only cash-basis taxpayers have structured their compensation arrangements to defer their fee income. However, the technical explanation of the provision released by the Joint Committee on Taxation takes the position that Section 457A applies to accrual-basis taxpayers as well.
- Section 457A generally does not apply to partnership allocations (though it does apply for purposes of determining when services income must be recognized by partnerships). For example, partnership allocations of “carry” on private equity investments (or hedge fund “side pockets”) of the partnership should not be affected by the provision.

Explanation

Section 457A generally requires compensation deferred under a “nonqualified deferred compensation plan” of a “nonqualified entity” to be included in income when there is no substantial risk of forfeiture of the rights to such compensation. This provision conceptually expands Section 457 of the Code, a longstanding provision that limits the deferral of compensation from tax-exempt entities but imposes fewer restrictions than Section 457A.

Under Section 457A, a “nonqualified deferred compensation plan” generally has the same meaning as that provided under Section 409A of the Code, which defines the term very broadly and generally imposes penalties on nonqualified deferred compensation failing to meet certain requirements. However, the Section 457A definition also includes any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient. While Section 409A applies only to cash-basis service providers, the technical explanation of the provision released by the Joint Committee on Taxation takes the position that Section 457A applies to accrual-basis taxpayers as well. In addition, compensation will not be treated as deferred if it is received within 12 months after the end of the taxable year during which there is no longer a substantial risk of forfeiture.

To be covered by Section 457A, a nonqualified deferred compensation plan must be the plan of a “nonqualified entity.” A nonqualified entity means a foreign corporation (unless substantially all of its income is effectively connected with a U.S. trade or business or is subject to a comprehensive foreign income tax) or a partnership (unless substantially all of its income is allocated to persons other than such foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax and tax-exempt organizations). For these purposes, a foreign income tax qualifies as comprehensive if the person is eligible for benefits under a U.S. comprehensive income tax treaty or otherwise demonstrates to the satisfaction of the Department of Treasury that the country has a comprehensive income tax. If a foreign person is eligible for such treaty benefits, there is no requirement that the foreign person also be subject to income tax in that jurisdiction.

Deferred compensation subject to Section 457A is included in income when a person’s right to the compensation is no longer subject to a “substantial risk of forfeiture.” This generally means when such right is no longer conditioned on the future performance of substantial services by any individual. To the extent provided in regulations, however, compensation determined solely by reference to gain on the disposition of an investment asset (without netting against losses from other assets) also will be treated as subject to a substantial risk of forfeiture until the date of disposition. For this purpose, “investment asset” means any single asset (other than an investment fund) that (i) is acquired directly by an investment fund, (ii) is not actively managed with the participation from the investment fund or any person related to the investment fund and (iii) substantially all of the gain on the disposition of which will be allocated to investors in the investment fund.

If the amount of compensation cannot be determined at the time the compensation must be included in gross income, the income must be included in gross income when it can be determined. The tax due will be increased by an interest charge and a penalty of 20% of the amount of compensation.

Section 457A generally applies only to deferred compensation attributable to services performed after 2008. Amounts otherwise subject to the provision but attributable to services performed before 2009 are required to be included in income no later than the last taxable year beginning before 2018 or, if later, when there is no substantial risk of forfeiture of the rights to the compensation.

The Department of Treasury will issue guidelines providing a window period during which nonqualified deferred compensation arrangements attributable to service performed before 2009 can be amended to conform to Section 457A's requirements without violating Section 409A.

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October 3, 2008

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