WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

NEW INTERNAL REVENUE CODE SECTION 457A MAY APPLY TO COMPENSATION PLANS OF PORTFOLIO COMPANIES OF PRIVATE EQUITY AND VENTURE CAPITAL FUNDS

Section 457A of the Internal Revenue Code (the "Code"), added by the Emergency Economic Stabilization Act of 2008 ("EESA"), generally requires any deferred compensation paid or payable under a "nonqualified deferred compensation plan" of a "nonqualified entity" that is attributable to services performed after December 31, 2008, to be included in income when it is no longer subject to a substantial risk of forfeiture. Unlike Section 409A, Section 457A generally prohibits employees and other service providers of "nonqualified entities" from deferring any compensation. Substantial penalties may be imposed if compensation is deferred.

Although the legislative history indicates that the primary purpose of Section 457A was to address deferrals by managers of offshore hedge funds, the definition of "nonqualified entity" in Section 457A is broad enough to pick up both onshore and offshore portfolio companies of venture capital and private equity funds.

Portfolio companies potentially affected will generally be limited to (i) entities organized in a so-called "tax haven" jurisdiction (i.e., one that is not subject to a comprehensive foreign income tax, such as Bermuda, the British Virgin Islands, or the Cayman Islands) and (ii) partnerships (including LLCs or other entities that are treated as partnerships for United States income tax purposes), regardless of where organized, unless substantially all of the income of the venture capital or private equity fund investing in such partnership is allocated to persons other than (A) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax and (B) organizations that are exempt from tax under the Code (e.g., retirement plans).

Although the title of Section 457A refers to "nonqualified deferred compensation from certain tax indifferent parties," the section may literally apply to a partnership whose partners are fully subject to tax by the United States on the income generated by the partnership. Unlike the version of Section 457A introduced in the House of Representatives on September 25, the version passed by the Senate and ultimately enacted as part of EESA classifies a partnership as a "nonqualified entity" even if all of its income is allocated to (i) foreign persons all of whose income is fully taxable by the United States as income effectively connected with the conduct of a United States trade or business ("ECI") or (ii) exempt organizations that are fully subject to tax because such income is unrelated business taxable income ("UBTI"). Such an entity is not tax indifferent in any reasonable sense of the phrase -- indeed it may be more tax sensitive than an entity subject to a comprehensive foreign income tax -- and so the reason for subjecting entities owned by persons subject to tax on ECI or UBTI is not obvious. It is likely that the United States Treasury would view itself as having the authority to provide relief in such cases under the broad grant of regulatory authority in Section 457A(e) to prescribe regulations "as may be necessary or appropriate to carry out the purposes of this section," but the issue might also be addressed in technical corrections legislation.

Accordingly, under Section 457A as enacted, an affected partnership or LLC would be deemed a "nonqualified entity" and its employees and other service providers would potentially be subject to the new restrictions on deferring compensation, if the entity is owned by a private equity fund that allocates more than an insubstantial part of its income to tax-exempt pension funds or foreign persons that are not subject to a comprehensive foreign income tax, even if its income is fully taxable to the exempt pension fund as UBTI or to the foreign persons as ECI. However, if the private equity fund holds the partnership or LLC interests through a blocker organized as a U.S. domestic corporation or uses an alternative investment vehicle employing such U.S. corporate blockers, as is sometimes the case, it would avoid "nonqualified entity" status since substantially all of its income would be allocated to persons other than foreign persons and exempt organizations.

Compensation arrangements maintained at a lower-tier corporate subsidiary of a nonqualified entity are outside the scope of Section 457A, provided such corporation is organized in the United States or another jurisdiction that imposes a comprehensive foreign income tax. If the portfolio company's compensation arrangements are maintained directly by the nonqualified entity, however, all compensation arrangements and pay practices of such entity under which any United States taxpayer is compensated need to be reviewed in order to identify whether they constitute "nonqualified deferred compensation plans."

In practice, the concern is that new Section 457A will result in the taxation of compensation deferred by employees of affected corporations, partnerships and LLCs as soon as the compensation is vested, in the sense that it is no longer conditioned upon the future performance of substantial services (as opposed to when it is actually paid), regardless of whether the underlying arrangement is otherwise fully compliant with Section 409A. This would change the timing for taxation of a wide variety of cash-based deferred compensation and phantom equity arrangements (including arrangements pursuant to which phantom partnership units, restricted stock units, and/or stock appreciation rights are granted), if such amounts are payable by a nonqualified entity. The same compensation arrangements would instead be excluded from Section 457A (and covered only by Section 409A) if the compensation were payable by a domestic corporate operating subsidiary of the nonqualified entity, or a foreign subsidiary that is subject to a comprehensive foreign income tax.

For a further discussion of the scope and operation of Section 457A, please see our memorandum entitled "New Tax on Nonqualified Deferred Compensation from Certain Tax-Indifferent Parties," dated October 3, 2008.

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