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Emergency Economic Stabilization Act: Offshore Deferred Compensation

Earlier today, President Bush signed the Emergency Economic Stabilization Act of 2008 (the "Act"). Included among the provisions added after the Act's failure to pass the House earlier in the week are certain limitations on the ability of fund managers and their employees to defer management and performance fees earned in connection with the operation of offshore private investment funds. The House and Senate had each separately adopted slightly different versions of this legislation earlier this year. The Act largely adopts the House's version (described in our Memorandum dated May 23, 2008, available here).

The Act adds a new Section 457A to the Internal Revenue Code of 1986, as amended (the "Code"), which generally eliminates the ability of US cash basis taxpayers to defer nonqualified deferred compensation earned from a so-called "nonqualified entity" (defined to include certain partnerships and foreign corporations)[1]. Any compensation that is deferred under a "nonqualified deferred compensation plan" (generally defined by Section 409A(d) of the Code) of such a nonqualified entity will generally be includible in the recipient's gross income when the right to the compensation is not subject to a "substantial risk of forfeiture." Compensation is subject to a "substantial risk of forfeiture" only if a person's rights to such compensation are conditioned upon the future performance of substantial services by such person. This definition is less expansive than the definition of the same term under the Section 409A regulations.

The Act also includes a provision that would impose an additional tax on amounts of compensation that are not determinable at the time there is no substantial risk of forfeiture – a provision that is specifically designed to reach performance or incentive fees related to offshore hedge fund side pockets, unless

[1] A partnership is a "nonqualified entity" unless substantially all of its income is allocated to persons other than (i) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax and (ii) organizations which are exempt from US federal income tax. A foreign corporation is a "nonqualified entity" unless substantially all of its income is either (i) effectively connected with the conduct of a trade or business in the United States or (ii) subject to a comprehensive foreign income tax. The term "comprehensive foreign income tax" means with respect to a foreign person the income tax of a foreign country if (i) such person is eligible for the benefits of a comprehensive income tax treaty between such foreign country and the United States or (ii) such person demonstrates to the satisfaction of the Secretary of Treasury that such foreign country has a comprehensive income tax.

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those fee arrangements satisfy certain conditions.[2] Side pocket performance fee arrangements that are not structured in accordance with Section 457A's requirements run the risk of becoming subject to an additional 20% tax when the deferred performance fee becomes determinable plus interest at the underpayment rate plus 1% on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture.

These provisions of the Act will apply to amounts deferred which are attributable to services performed after December 31, 2008. Amounts deferred that are attributable to services performed before January 1, 2009, will be includible in income on the later of (i) the last taxable year beginning before 2018 or (ii) the taxable year when the amount deferred is no longer subject to a substantial risk of forfeiture.

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[2] To avoid application of Section 457A, the side pocket performance fee would have to be determined solely by reference to the amount of gain recognized on the disposition of an "investment asset". For this purpose, an investment asset is generally defined as any single asset (other than an investment fund or similar entity) (i) acquired directly by an investment fund, (ii) with respect to which such entity does not participate in the active management of such asset and (iii) substantially all of any gain on the disposition of which (other than the nonqualified deferred compensation) is allocated to investors of such entity.

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