

Hedge Fund Alert

A periodic update on trends and developments affecting the industry

Final Section 409A Regulations and Their Effect on Offshore Hedge Fund Deferral Arrangements

As reported earlier, in Goodwin Procter's [February 2005 Hedge Fund Alert](#), Congress enacted Section 409A of the Internal Revenue Code as part of the American Jobs Creation Act of 2004. Section 409A places certain restrictions on nonqualified deferred compensation arrangements. Due to the widespread use of deferred fee arrangements in the offshore hedge fund world, the broad scope of the statute, and the considerable penalty tax (20% plus interest), Section 409A raises many important issues for hedge fund managers to consider.

The IRS and Treasury have adopted Final Regulations with respect to Section 409A. These become effective as of January 1, 2008, but may be relied upon prior to that date. Prior guidance, including the proposed regulations that were issued in 2005, provided little guidance to investment managers of hedge funds although they did provide some guidance on back-to-back deferral arrangements that are commonly found in the offshore hedge fund context. The Final Regulations clarify that Section 409A will apply to investment managers and provide welcome flexibility with respect to some back-to-back arrangements although they do not provide additional guidance relating to offshore funds. Since the grace period for amending covered arrangements ends on December 31, 2007, managers should begin their review of these arrangements now.

Section 409A Background

Section 409A places specific requirements on certain deferred amounts which, if not followed, will cause the amounts to be subject to current taxation and a 20% penalty tax plus interest charges. Under the statute, a "nonqualified deferred compensation plan" includes any plan or arrangement that provides for the deferral of compensation. To avoid current taxation, the penalty tax and interest, a deferral arrangement must comply with the technical provisions of Section 409A. These provisions generally govern the timing of initial and subsequent deferrals, the form and time of distributions, and the acceleration of distributions under certain limited circumstances.

Section 409A and the Provision of Services to Hedge Funds

The Final Regulations explicitly provide that, despite the exception under Section 409A for independent contractors, Section 409A will apply to services that involve the provision of investment management or advisory services to a service recipient whose primary trade or business includes the investment of financial assets (including investments in real estate), such as a hedge fund or a real estate fund.

Although the Final Regulations provide welcome additional guidance, they do not address one area of particular concern to offshore hedge funds. As we noted in [our earlier alert](#), Section 409A prohibits the funding of deferral arrangements through trusts or other arrangements located outside the United States. Although the statute was intended to cover offshore rabbi trusts the assets of which are not subject to the claims of U.S. creditors, the language could be interpreted to include offshore hedge fund deferral arrangements despite the fact that the amounts deferred in hedge fund deferral arrangements are typically subject to the claims of creditors. Although guidance was issued in 2006 that applies specifically to offshore trusts, that guidance did not address offshore hedge fund deferrals. The Final Regulations offer no further guidance regarding the application to offshore funds. Accordingly, while it is necessary for back-to-back deferral arrangements to comply with the Final Regulations, investment managers must be aware that their deferral arrangements with offshore funds may still be in violation of Section 409A, despite following its other technical provisions.

Deferral Elections

In general, the Final Regulations simply clarify the proposed regulations. Under the Final Regulations, initial elections must be made prior to the beginning of the delivery of services with respect to which the compensation will be deferred, and must state the time and form of distribution. This usually means that deferral elections must be made no later than December 31 of the year immediately preceding the year in which services will begin. However, there are two exceptions, one for performance-based compensation and another for fiscal year compensation, that will be of interest to hedge fund investment managers.

- In the case of an election to defer performance-based compensation (such as incentive fees) based on services performed over a period of at least 12 months, the election may be made no later than six months before the end of the service period provided that it is substantially uncertain at that time whether the performance criteria will be met by the end of the period. For example, if the performance period begins on January 1, 2008 and ends on December 31, 2008, the deferral election must be made no later than June 30, 2008. However, because management fees are not performance-based, deferrals with respect to management fees must be made prior to the beginning of the calendar year in which services begin (*i.e.*, in this example, December 31, 2007).
- For service recipients that have a taxable year that is not the same as the taxable year of the service provider, a plan may provide that fiscal year compensation (*e.g.*, bonus compensation that relates solely to the non-calendar fiscal year but not regular salary or quarterly bonuses) may be deferred at the service provider's election if the election to defer such compensation is made no later than the close of the service recipient's taxable year immediately preceding the first taxable year of the service recipient in which any services are performed for which the compensation is payable. For example, if a fund has a July 1, 2007 to June 30, 2008 fiscal year, a plan may provide that the service provider may make an election with respect to annual incentive compensation no later than June 30, 2007.

Permissible Payment Events

Permissible payment events are limited under Section 409A. With respect to individual service providers, they include the following: (i) the service provider's separation from service, (ii) the service provider becoming disabled (as defined in the Final Regulations), (iii) the service provider's death, (iv) a time or a fixed schedule specified under the plan, or (v) the occurrence of an unforeseeable emergency. The Final Regulations clarify the circumstances under which these payment events will operate in the context of back-to-back deferral arrangements.

Back-to-Back Deferral Arrangements

Very often, the investment manager which has entered into a fee deferral arrangement with the hedge fund will also have entered into a "back-to-back" deferral arrangement with its employees whereby the employees become entitled to payment when the manager receives its deferred fees from the hedge fund. It is also not uncommon for an arrangement between a hedge fund and an investment manager to provide that the hedge fund will distribute deferrals to the investment manager when an employee has a payment event such as separation from service or death. The proposed regulations offered some guidance on these latter arrangements, and the Final Regulations provide further clarity.

Under the Final Regulations, back-to-back nonqualified deferred compensation arrangements can be designed to comply with Section 409A in circumstances in which an employee is providing services to a service recipient such as the investment manager (the intermediate service recipient), which in turn is providing services to another service recipient such as a hedge fund (the ultimate service recipient), and the services provided by the employee to the intermediate service recipient are closely related to the services provided by the intermediate service recipient to the ultimate service recipient. The arrangement between the fund and the investment manager and that between the investment manager and the employee will each have to meet all the technical provisions of Section 409A such as the provisions relating to the timing of deferral elections and permissible payment events.

If the above requirements are met, upon the occurrence of a permissible payment event for the employee such as the separation from service of the employee from the investment manager, the fund may pay to the investment manager the amount of deferred compensation that the investment manager owes to the employee despite the fact that the investment manager continues to provide services to the fund.

Unfortunately, the Final Regulations are silent regarding whether distributions can be made to a service provider where the payment to the service provider would be based upon a required payment from the ultimate service recipient to the intermediate service recipient (known as a "reverse back-to-back arrangement"). For example, an intermediate service recipient that provides investment management services to a fund may have an arrangement whereby the fund is required to pay all amounts due to the investment manager if the fund terminates the client relationship, and the investment manager in turn may have an agreement with an employee to pay the employee a certain percentage of the payment from the fund to the investment manager at the same time that the investment manager receives the payment. The preamble to the Final Regulations

notes that commentators had requested that the exception from the general payment timing rules for certain back-to-back arrangements be expanded to cover reverse back-to-back arrangements; however, the preamble states that these arrangements remain under consideration for further guidance. Therefore, whether such a payment event can be made to comply with Section 409A remains uncertain.

Effective Dates

There will be no additional transition relief after December 31, 2007, and the written documentation evidencing nonqualified deferred compensation arrangements must be in compliance by January 1, 2008. Accordingly, hedge fund managers are encouraged to consult their tax advisors as to the application of Section 409A to their specific deferral arrangements well in advance of the December 31 deadline.

If you would like additional information about the issues addressed in this client alert, please contact:

Elizabeth Shea Fries	efries@goodwinprocter.com	617.570.1559
Adrienne A. Scerbak	ascerbak@goodwinprocter.com	212.813.8843
Marian A. Tse	mtse@goodwinprocter.com	617.570.1169
Scott A. Webster	swebster@goodwinprocter.com	617.570.8229

Full access to all articles on hedge funds prepared by Goodwin Procter is available at:
<http://www.goodwinprocter.com/Publications/Full%20Publication%20Index.aspx>

Full access to all articles prepared by Goodwin Procter is available at:
<http://www.goodwinprocter.com/PublicationSearchResults.aspx?search=all>

This publication, which may be considered advertising under the ethical rules of certain jurisdictions, is provided with the understanding that it does not constitute the rendering of legal advice or other professional advice by Goodwin Procter LLP or its attorneys. Additionally, the foregoing discussion does not constitute tax advice. Any discussion of tax matters contained in this publication is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code or promoting, marketing or recommending to another party any transaction or matter. © 2007 Goodwin Procter LLP. All rights reserved.