DAVIS POLK & WARDWELL

Date: October 22, 2008

To: Interested Persons

Re: Section 457A

---

The Emergency Economic Stabilization Act of 2008 ("EESA"), which President Bush signed on October 3, added Section 457A to the Internal Revenue Code.[1] Under the new provision, managers of offshore hedge funds will no longer be able to defer the recognition of incentive fees and management fees payable by the funds. Moreover, the effect of the provision is not limited to hedge fund managers, nor is it limited to persons that have made affirmative deferral elections. Section 457A does not, however, affect the treatment of carried interest allocations made by private equity, venture capital, real estate or similar funds or the treatment of incentive allocations made by hedge fund partnership vehicles, such as a master fund or a "mini-master."

In general, Section 457A applies to deferred compensation that is ***attributable to services performed after December 31, 2008***. Persons that would be affected by the provision thus have a narrow window of time in which to restructure their arrangements for services performed after that date.

Under Section 457A, compensation for services provided to a "***nonqualified entity***" pursuant to a "***nonqualified deferred compensation plan***" must be taken into account for tax purposes when the compensation has been earned economically and there is no "***substantial risk of forfeiture***" of the right to such compensation. A "nonqualified entity" is generally defined as:

(i) any foreign corporation unless substantially all of its income is either subject to a comprehensive foreign income tax or treated as "effectively connected" with the conduct of a trade or business in the United States; or

(ii) any partnership unless substantially all of its income is allocated to persons other than (x) foreign persons that are not subject to a comprehensive foreign income tax in respect of such income and (y) tax-exempt organizations.[2]

---

[1] All "Section" references herein are to the Internal Revenue Code.

[2] If a foreign person is eligible for the benefits of a comprehensive income tax treaty between the United States and a foreign country, a "comprehensive foreign income tax" means the income tax of that foreign country. Otherwise, the income tax of a foreign country will be treated as a "comprehensive foreign income tax" only if the foreign person can demonstrate to the satisfaction of the Treasury Department that the foreign country has a comprehensive income tax.

The definition of "nonqualified entity" thus includes the typical offshore hedge fund entity. It also includes various other entities, however, such as a private equity partnership the investors in which are all tax-exempt organizations and certain offshore insurance companies.

The enactment of Section 409A in 2004 introduced certain restrictions with respect to "***nonqualified deferred compensation plans***." Section 457A applies in addition to Section 409A, and while its application is limited to compensation paid by "nonqualified entities," in certain respects it has a broader scope than Section 409A.[3] In particular, while Section 409A applies only to service providers that are cash-basis taxpayers, Section 457A may apply to accrual-basis taxpayers, as well.[4] Moreover, Section 457A has a more restricted definition of "***substantial risk of forfeiture***" than does Section 409A.

Under Section 457A, a right to compensation will generally be treated as subject to a "***substantial risk of forfeiture***" ***only*** if it is conditioned on the future performance of substantial services by an individual. A substantial risk of forfeiture will therefore not be considered to exist merely because the service provider's right to receive the compensation is subject to any other condition, such as the subsequent performance of any investments. By contrast, under Section 409A, a right to compensation will also be treated as subject to a "substantial risk of forfeiture" if it is subject to the occurrence of a condition related to the purpose of the compensation (such as the attainment of a prescribed level of earnings) and the possibility of forfeiture is substantial. Thus, for example, the right to receive a fee that is equal to a percentage of the gain recognized by the service recipient on the future sale of an investment asset will not be treated as subject to a substantial risk of forfeiture under Section 457A merely because of the risk that the relevant asset will not appreciate in value, even though this risk would under many circumstances be treated as a substantial risk of forfeiture for purposes of Section 409A.

Section 457A provides that if the amount of any deferred compensation is not determinable at the time that it is required to be included in income under Section 457A, the compensation will be taken into account when it becomes determinable, but the tax liability will be ***increased by an amount equal to 20%***

[3] Certain aspects of the overlapping application of Section 409A and Section 457A are not clear and will have to be addressed in Treasury regulations.

[4] One version of the proposed legislation specifically provided that Section 457A would apply to accrual-basis taxpayers. Although this version was not adopted, Section 457A does not provide that it applies only to cash-basis service providers. Significantly, although Section 457A defines the term "nonqualified deferred compensation plan" by reference to Section 409A, it does not contain a definition of "service provider" that references Section 409A.

***of the compensation, as well as by an interest charge*** (the "**Increased Tax Rule**"). Because of Section 457A's narrow definition of "substantial risk of forfeiture," the Increased Tax Rule would apply to certain investment management fees that are equal to a percentage of the appreciation in the value of an investment asset over a multiple-year period (*e.g.*, a private equity investment or a "side pocket" investment in a hedge fund). As a result, Section 457A may have significant adverse consequences even for investment managers that have not made affirmative fee deferral elections.

Section 457A grants the Treasury Department authority to promulgate regulations that would expand the definition of "substantial risk of forfeiture" in the case of compensation that is determined solely by reference to the amount of gain recognized on the disposition of an "***investment asset***": to the extent provided in these regulations, this type of compensation would be treated as subject to a substantial risk of forfeiture until the date of the relevant disposition. An "investment asset" generally would include any single asset acquired directly by an investment fund or similar entity, but would not include an investment fund or similar entity itself.[5] The legislative history of Section 457A states, however, that this rule would not apply if the amount of compensation were reduced for losses on the disposition of any other assets. As a result, even if these regulations are adopted, they are unlikely to apply to many typical situations in which investment managers receive fees attributable to the performance of "side pocket" or other long-term investments.

For purposes of Section 457A, a "***nonqualified deferred compensation plan***," is generally defined in the same manner as under Section 409A. Unlike Section 409A, however, Section 457A treats as a "nonqualified deferred compensation plan" any plan that provides a right to compensation based on the appreciation in value of the equity of the "nonqualified entity."[6] Compensation will not be treated as deferred for purposes of Section 457A if it is paid no later than twelve months after the end of the service recipient's taxable year during which any "substantial risk of forfeiture" lapsed.[7]

---

[5] An asset would not constitute an "investment asset" if the investment fund, or any person related to the fund, participated in the active management of the asset or, if the asset is an interest in an entity, in the active management of the activities of such entity. The legislative history states that, for this purpose, active management would include participation in day-to-day activities, but not the election of a director or other voting rights exercised by shareholders.

[6] Under Section 409A, by contrast, a right to compensation based on the appreciation in value of a specified number of shares of the service recipient's stock will under certain circumstances not be treated as deferred compensation.

[7] The extent to which the Increased Tax Rule will affect investment managers that receive fees based on the amount of gain derived from the disposition of an investment asset depends on the extent to which Section 457A incorporates the Section 409A definition of "nonqualified deferred compensation plan." In general, Section 409A defines a "nonqualified deferred

As discussed above, Section 457A applies to deferred compensation that is attributable to services performed after December 31, 2008. In addition, if any deferred compensation that is attributable to services performed before 2009 has not been included in income ***before 2018***, it must be included in income in the last taxable year beginning before 2018 unless the compensation is still subject to a "substantial risk of forfeiture" at such time.

Section 457A directs the Treasury Department to issue guidance, within 120 days after the enactment of EESA, providing a limited period of time during which existing arrangements may be amended to conform the date of distribution to the date on which the deferred amounts are required to be included in income under Section 457A.[8] Guidance will also be needed to address various questions about the application of Section 457A, which are currently unclear.

If you have questions regarding this memorandum, please call your regular Davis Polk contact.



---

compensation plan" as any agreement or arrangement that provides for the "deferral of compensation," other than certain "qualified" plans. Treasury regulations under Section 409A contain a "short-term deferral" rule, under which there is generally no "deferral of compensation" for purposes of Section 409A if the service provider receives the compensation within a specified period after the right to the compensation is no longer subject to a "substantial risk of forfeiture," as defined for purposes of Section 409A. Under this definition, a fee that is based on the amount of gains derived from the disposition of an investment asset would under many circumstances not constitute deferred compensation if it were paid within the period specified in the "short-term deferral" rule. Because Section 457A defines "nonqualified deferred compensation plan" by reference to Section 409A, it is possible that the Section 409A rule on short-term deferrals is fully incorporated into Section 457A, even though it is based on a standard of "substantial risk of forfeiture" that is different from the Section 457A standard. If this view is correct, many fees that are contingent on the amount of gain derived from the disposition of an investment asset would not constitute deferred compensation to which Section 457A applies. It may, however, be difficult to reconcile this interpretation with the regulatory authority granted by Section 457A that permits the Treasury Department to expand the definition of "substantial risk of forfeiture" in the case of compensation that is determined solely by reference to the amount of gain recognized on the disposition of an investment asset. If this compensation was not generally intended to be treated as deferred compensation for purposes of Section 457A, the exception would be of utility only in fairly limited circumstances.

[8] This transition relief will also permit amendments to back-to-back arrangements, common with hedge fund managers, pursuant to which an investment management entity that has a deferred compensation plan with an offshore hedge fund also has a corresponding plan with its employees or members.