Proposed Regulations under Internal Revenue Code § 409A

The IRS has issued *proposed* regulations under Internal Revenue Code § 409A ("nonqualified deferred compensation"). The regulations contain several items of special interest to hedge funds and their advisors.

- **No Independent Contractor Exception.** It was hoped that the IRS would expand a limited "independent contractor" exception (contained in earlier guidance) to encompass most hedge fund/advisory company arrangements. The proposed regulations take the opposite approach and make it clear that deferral arrangements between an advisory company and a fund it advises generally must comply with § 409A (unless the advisory company is an accrual basis taxpayer though even in that case any arrangement between the advisory company and the cash basis individual managers would have to comply with § 409A).
- **Relief for Back-to-Back Arrangements.** § 409A restricts when deferred compensation may be paid. Permissible "triggers" include a separation from service, disability, death, a corporate change in control, or an unforeseeable emergency, although payment may also be made at a time or pursuant to a fixed schedule specified in advance. Narrowly construed, these restrictions might not permit a hedge fund to pay deferred fees to its advisory company merely because a manager under the company's "back-to-back" plan had experienced a qualifying payment event (for example, separation from the company's service). Helpfully, the proposed regulations take a liberal view of these rules and permit the fund/advisory company portion of a back-to-back arrangement to pay out based on qualifying payment events under the advisory company/manager plan.
- **Fiscal Year Deferral Elections.** Under § 409A, most deferral elections must be made before the taxable year in which the relevant services are rendered. It had been unclear how to apply this rule to compensation earned on a fiscal-year basis. The proposed regulations permit elections to be made on a fiscal year basis with respect to "fiscal year compensation" (for example, certain bonuses). However, the relief is likely to be of no utility to fund managers with back-to-back plans since the proposed regulations do not permit such managers to make the election by reference to a fiscal year of an entity other than the entity to which they provide services (i.e., the advisory company, which is likely to be on a calendar year).
- **Performance-Based Compensation and Deferral Elections.** The rule requiring elections before the beginning of the service year is relaxed for "performance-based" compensation earned over a performance period of at least twelve months. Where applicable, the special "performance-based" compensation rule permits a deferral election to be made as late as six months prior to the end of the period. Under the proposed regulations, appreciation in the value of the service recipient or its stock can qualify as a measure of "performance" for this purpose. However, because there is no express extension of the relief to back-to-back arrangements, it remains highly doubtful whether a fund manager could delay a deferral election under the advisory company's plan merely because the underlying incentive compensation was based on performance of the hedge fund to which the company provides services.
- **Funding Arrangements.** § 409A penalizes off-shore trust funding of deferred compensation and extends the same adverse tax treatment to "other arrangements" specified by the IRS. Apart from some guidance on broad-based non-U.S. plans, the proposed regulations provide no rules in this area. Thus, it remains unclear whether the

IRS might view an off-shore hedge fund as an impermissible "funding" of nonqualified deferred compensation, for example with respect to amounts owed to the advisory company under a back-to-back arrangement.

- **Effective Date.** The regulations are only proposed. As proposed, they generally will not take effect before January 1, 2007. Until then, taxpayers are told that they are to proceed on the basis of good-faith compliance with the statute, the IRS's earlier-published interim guidance, and any other published guidance of general applicability with an effective date earlier than January 1, 2007. To the extent an issue is not addressed in these sources, the preamble to the regulations states that a plan must follow a good faith, reasonable interpretation of the statute and, to the extent not inconsistent with the statute, the plan terms.
- **Taxpayers may rely on the proposed regulations.** However, it is not clear what effect, if any, the issuance of the regulations may have on what is deemed "reasonable" reliance on the statute. On several important topics, the regulations articulate unanticipated positions, in some cases described as "clarifications," that are surprisingly restrictive.
- **Transition Relief.** Taxpayers will have until December 31, 2006 to bring documents into formal compliance with 409A and to adjust existing payout elections. (These are extensions of existing relief deadlines.) The regulations do not extend the December 31, 2005 deadline for terminating/cashing out existing deferrals. Thus, clients will have to review their existing arrangements immediately to determine whether to offer a cash-out.

This Client Alert is intended to be a general description of certain developments under Section 409A. Since these rules are complex and their applicability to any taxpayer depends on the taxpayer's specific circumstances, this communication is not intended to be and should not be understood as tax advice and cannot be relied upon by any taxpayer to avoid U.S. tax penalties.

Contact Information

To discuss the proposed regulations and their effect on hedge funds, please call or email your regular Ropes & Gray attorney.