Congress Blocks Offshore Hedge Fund Deferrals

The Emergency Economic Stabilization Act of 2008 (H.R. 1424, commonly referred to as the "bailout" legislation) enacted on October 3 adds a new provision to the Internal Revenue Code (Section 457A) that will effectively put an end to most ongoing offshore hedge fund deferral programs.

Applicability

Section 457A largely eliminates the ability to defer compensation payable from an offshore corporation unless substantially all of the income of that corporation is subject to net basis U.S. taxation or is otherwise subject to a comprehensive foreign income tax (defined to require, in general, that there be a comprehensive income tax treaty between the country in question and the United States). A similar deferral prohibition applies to a partnership unless substantially all of its income is allocated to persons who are U.S. taxable investors or foreign persons with respect to whom the income is subject to a comprehensive foreign income tax. In other words, Section 457A is aimed at eliminating deferrals from tax-haven jurisdictions or from pass-through entities unless the partners are subject to tax.

Although the legislation contains some exceptions to this general rule, including one for payments received not later than 12 months after the end of the taxable year in which the right to payment vests (determined under the legislation's restrictive definition of vesting), new Section 457A in most cases will prevent the types of compensation deferral that have been common in many, if not most, hedge fund investment management arrangements involving offshore funds.

Side-Pocket Issues

Vested compensation that is "not determinable" is required by Section 457A to be taken into income only when it becomes determinable, but is then subject to an additional 20% tax as well as an interest charge.

It is not clear how this provision would apply to amounts payable in respect of illiquid "side pockets." Helpfully, Section 457A states that—to the extent provided in future regulations—compensation determined "solely" by reference to the amount of gain recognized on the disposition of an "investment asset" will be treated as subject to a risk of forfeiture and, therefore, not subject to the 20% additional tax and interest charge solely by reason of the "not determinable" rule. However, the investment asset exception may not apply to a hedge fund otherwise subject to Section 457A if the fund nets side-pocket gains (when realized or realizable) from an investment asset against the fund's other income for purposes of determining the manager's incentive compensation. In addition, Section 457A's definition of "investment asset" may limit the availability of the exception in the absence of regulatory relief, and the investment asset exception cannot be combined with the 12 month exception discussed above to further defer inclusion in income.

Effective Dates, Grandfathering Rules and Expected Transition Relief

Section 457A prevents the deferral of compensation earned for services performed after December 31, 2008. Amounts

representing compensation for a fiscal year ending in 2009 may, therefore, not be deferrable (absent IRS relief) even if a portion is payable for services performed before January 1, 2009.

The legislation contains limited transition relief for deferred compensation attributable to services performed before January 1, 2009, which must be included in income (if not payable earlier) no later than the last year beginning before 2018—unvested amounts could remain unpaid until vested. For calendar year managers, inclusion will generally be required by 2017. Treasury has been directed to issue transition relief to allow taxpayers to modify their deferral plans (including "back-to-back" plans) to comply with Section 457A without violating Section 409A.

Note that the Act did not contain other provisions previously associated with anti-deferral efforts, such as the "$1 million" cap on deferred compensation or the limited relief from debt-financed "unrelated business taxable income" rules for tax-exempt investors in partnerships.

Restructuring Possibilities

In response to Section 457A, managers of offshore hedge funds subject to these rules but generating long-term capital gains may wish to change the form of their incentive for services performed subsequent to December 31, 2008 from a fee to a partnership allocation. Those funds currently structured as offshore corporations should consider a partnership "mini-master" fund structure. Partnership tax accounting rules may effectively limit the ability of funds that previously used a fiscal year incentive schedule to maintain that schedule subsequent to a conversion to a partnership, however, and managers should also be aware that other proposed legislation approved by the House of Representatives earlier this year (and that may be considered by Congress in the future) would treat most manager/general partner partnership incentive allocations as ordinary income.

For more information regarding Section 457A, please contact a member of the Tax & Benefits Department or your regular Ropes & Gray attorney.

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