

## IRS Releases Further Guidance Affecting Offshore Hedge Fund And Other Pooled Investment Vehicle Deferrals

### IRS Issues Interim Guidance Under Section 457A

The IRS last week issued interim guidance (Notice 2009-8) under Internal Revenue Code Section 457A. Enacted in October 2008 (see our [October 6 Alert](#)), Section 457A largely eliminates compensation deferrals by nonqualified entities (NQEs)—in general, tax-indifferent non-U.S. corporations or partnerships (U.S. or non-U.S.) with tax-indifferent partners.

### Effective Date and Transition Relief

The basic restrictions of Section 457A, where it applies, affect only deferrals attributable to services performed after December 31, 2008, although pre-2009 deferrals may have to be unwound eventually (see below). The Notice provides rules for allocating amounts to pre-2009 and post-2008 periods and includes a potentially valuable transition rule in cases where compensation would be attributable to a post-2008 period because of a service-based vesting condition (for example, a requirement that the service provider continue in service through the end of 2009 to get paid anything). If a service-based vesting condition in existence on December 31, 2008 is eliminated by June 30, 2009 and if the same change is made to substantially similar arrangements involving the same service recipient and the same or similarly situated service providers, amounts deferred under the arrangements that because of the vesting condition would otherwise be allocated to post-2008 periods will be treated as allocable to pre-2009 services and thus not subject to Section 457A's basic anti-deferral rules.

### Adjusting Pre-2009 Deferrals; Paying Out Post-2008 Deferrals

Deferrals that are attributable to pre-January 1, 2009 services are not immediately affected by Section 457A but unless accelerated will be includible in income not later than the last taxable year beginning before January 1, 2018 or, if later, the first taxable year in which the right to payment vests. Where an existing two-party or back-to-back deferral, including a pre-2005 deferral that is grandfathered for Section 409A purposes, contemplates payment in a later year, the Notice gives parties until **December 31, 2011** to accelerate payment to match this taxable event. (However, the Notice does not appear to permit accelerating pre-2009 deferrals to any earlier year.) It appears that if the 2011 deadline is missed, a plan will not then be able to accelerate payment except in compliance with the rules of Section 409A. However, the Notice separately provides that where deferrals attributable to post-2008 services are required to be included in income pursuant to Section 457A, "until further guidance" the deferred amount may be paid during the service provider's year of inclusion without violating Section 409A.

### What Compensation is "Deferred"?

Section 457A states that a payment will be treated as not deferred for Section 457A purposes if made no later than 12 months after the end of the service recipient's (e.g., a hedge fund's) taxable year in which the right to payment vests. The Notice clarifies that only actual payment is required to avoid 457A and that the documents do not themselves need to provide that the payment be made. Consequently, certain arrangements may still be terminated provided that the payment would be otherwise permitted by Section 409A. If the 12-month deadline is missed, the deferred amounts (if determinable) will be retroactively included in income for the year when vesting occurred.

## The “Indeterminability” Rule

Deferred compensation that is not determinable when the right to payment vests is taxable under Section 457A only when the amount does become determinable, but the tax is then increased by 20% of the amount of compensation plus an additional amount in the nature of interest (the “premium interest tax”).

For purposes of this rule, the Notice treats amounts as not “determinable” if at the end of the service provider’s taxable year the amount of the payment is unknown because it is based on factors that remain variable. Although facts and circumstances will dictate the result in any particular case, the Notice states, as an example, that a deferred fee based on net profits for a given period would be viewed as not “determinable” until the end of that period.

## What Plan Sponsors Are Covered by Section 457A?

Most offshore hedge funds will be treated as NQEs because they are organized in tax-haven jurisdictions as entities classified as corporations for U.S. tax purposes. Under the Notice, Section 457A will not apply if at least 80% of a plan-sponsor corporation’s gross income is U.S.-source “effectively connected income” (ECI), or to the extent the deferred compensation is deductible against the plan sponsor’s ECI, but these exceptions will not be materially relevant to most hedge funds. In general, a corporation also will not be an NQE if it is both eligible for the benefits of an income tax treaty between its country of residence and the U.S. (the treaties with Bermuda and the Netherlands Antilles are not recognized for this purpose, however) and is not subject to a beneficial tax regime in its country of residence. This latter requirement may disqualify (i.e., result in classifying as NQEs), among others, certain Irish or Luxembourg corporations.

Section 457A can also apply to plan sponsors that are classified as partnerships for U.S. tax purposes. Under the Notice, in general, a partnership will be an NQE unless at least 80% of its gross income is allocated to persons subject to tax on the income.

The Notice also clarifies that accrual-basis service providers are in fact covered by Section 457A. Although most hedge fund managers operate on a cash basis, managers of other funds (e.g., investment managers owned by corporations) are often accrual-basis taxpayers. Accrual-basis managers may be affected by Section 457A to the extent they do not receive fees on a current basis.

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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