

Client Alert

Financial Markets Developments

EESA Does It: New Recovery Law Prohibits Certain Offshore Tax Deferrals for Fund Managers

Andrew L. Oringer

I. Background

Last week, on October 3, 2008, the Emergency Economic Stabilization Act of 2008 (“EESA”) was signed into law. EESA generally provides the US Department of the Treasury (“Treasury”) with sweeping authority to purchase up to US\$700 billion of unsound financial assets held by banks and other financial firms that played a part in disrupting the global credit and other financial markets. Under the Troubled Asset Recovery Program (the “TARP”) created by EESA, Treasury is authorized to buy certain troubled mortgage-related instruments from affected institutions. See also our October 3, 2008 [Client Alert](#), regarding the EESA provisions relating to executive compensation.

EESA does more than establish the TARP. One of EESA’s non-TARP provisions adds a new Section 457A to the Internal Revenue Code of 1986 (the “Code”). New Section 457A will generally prohibit the federal tax deferral of compensation by those who provide services to certain offshore “tax-indifferent” partnerships or foreign corporations, whether or not the compensation is funded or otherwise secured. This provision had previously been proposed for enactment as a part of the so-called “extenders” process and is now law. Section 457A may be of particular relevance—and concern—for hedge funds and other investment funds using offshore entities and for their managers.

II. Historical Limitation on Deferrals of Compensation from Tax-Exempt Entities

Generally, when a service provider defers compensation, the service provider defers tax on the compensation at the cost of the service recipient’s deferral of the corresponding tax deduction. The resulting tension between the service provider and the service recipient may tend as a practical matter to constrain tax-motivated deferrals of compensation. When the service recipient is exempt from US taxation, this natural tension is no longer present because, while the service provider will derive a tax benefit from the deferral, there is no deduction to be deferred by the service recipient.

In light of the foregoing, Section 457 of the Code has for some time limited the payment of tax-deferred compensation by certain tax-exempt entities. Section 457 may be characterized as recognizing that a tax-exempt entity does not have the same tax-based disincentive for resisting a service provider’s deferral request as a taxable entity.



White & Case LLP is a leading global law firm with more than 2,400 lawyers in 37 offices in 25 countries. Whether in established or emerging markets, the hallmark of White & Case is our complete dedication to the business priorities and legal needs of our clients.

.....

If you have questions or comments regarding this Alert, please contact one of the following lawyers:

Andrew L. Oringer
Partner
Executive Compensation
and Benefits Practice
+ 1 212 819 8561
aoring@whitecase.com

Kenneth A. Raskin
Partner
Executive Compensation
and Benefits Practice
+ 1 212 819 8508
kraskin@whitecase.com

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
+ 1 212 819 8200

www.whitecase.com

III. New Section 457A

A. In General

New Section 457A limits deferred compensation paid by certain offshore tax-indifferent entities. Section 457A is designed fundamentally to address the special case where the offshore service recipient provides nonqualified deferred compensation to a taxable service provider, but would derive no tax benefit in the United States—or elsewhere—from paying the compensation on an earlier date. In the case of such an entity, as with a tax-exempt entity covered by Section 457, there again may not be a tension between a service provider's possible desire for tax deferral and a service recipient's possible desire to take a current deduction. Congress has addressed this situation by prohibiting the tax deferral of fees paid by such an entity in certain circumstances. In particular, Section 457A, where applicable, addresses the service recipient's indifference to the deduction by accelerating taxation of the service provider's deferred compensation to the date on which the right to payment is no longer subject to a substantial risk of forfeiture.

The enactment of Section 457A appears to have been fueled by political concerns with a perceived inequity resulting from the ability of various highly paid managers of hedge funds and other investment funds to achieve a substantial tax deferral. Many such funds are structured with the use of offshore entities, where the tension between the service provider's desire to defer taxation of compensation, on the one hand, and a service recipient's desire to obtain a current tax deduction for the compensation, on the other, is not present. Thus, while Section 457A on its face could apply to a range of different types of businesses, the practical effect of the new rules may well fall disproportionately on the managers of hedge funds and other investment funds.

B. Specific Provisions

New Section 457A imposes an outright prohibition on tax deferrals in specified circumstances, generally with respect to compensation for services rendered after 2008. (Note that this approach is in contrast to the approach under Section 409A of the Code, which for the first time comprehensively codifies the federal income-tax treatment of nonqualified deferred compensation and which provides rules under which deferrals may be permitted.) Special rules apply in the case of certain amounts deferred which are not subject to Section 457A solely because the applicable services were performed before 2009.

Section 457A generally prohibits a service provider from deferring (for tax purposes) compensation from any service recipient that is a "nonqualified entity," other than in the case of certain deferrals not extending beyond the year following the year in which the compensation vests. Once Section 457A applies, it has a potentially broad scope; for example, certain types of equity arrangements (possibly, even if exempt from the application of Section 409A) may not escape the reach of Section 457A.

Under Section 457A, the taxation of the service provider's compensation is accelerated to the date on which the right to such compensation is no longer subject to a substantial risk of forfeiture, regardless of whether the compensation is funded or unfunded and regardless of whether the compensation is otherwise secured or unsecured. Section 457A gives Treasury the ability to provide that compensation determined solely by reference to the amount of gain recognized on the disposition of an investment asset shall be treated as subject to a substantial risk of forfeiture until the date of disposition. If the amount of any compensation is not determinable at the time that the compensation would otherwise be taxable under Section 457A, such amount is taxable when determinable, and is then subject to a 20 percent additional tax and interest.

Section 457A defines a “nonqualified entity” as a foreign corporation unless “substantially all” of the income of the corporation is effectively connected with the conduct of a US trade or business or is subject to a “comprehensive foreign income tax.” A nonqualified entity also includes a foreign or domestic partnership unless “substantially all” of the income of the partnership is allocated to persons other than (i) foreign persons with respect to whom such income is not subject to a “comprehensive foreign income tax” or (ii) tax-exempt organizations. Section 457A defines a “comprehensive foreign income tax” with respect to any foreign person as the income tax of a foreign country if (i) such person is eligible to claim the benefits of a comprehensive income-tax treaty with the United States or (ii) such person satisfactorily demonstrates that such foreign country has a comprehensive income tax. (The new rules also do not apply with respect to certain foreign corporations not subject to tax on substantially all of their income, but that would be eligible to claim a deduction against such effectively connected income by paying the compensation on the date that the right to such payment was no longer subject to a substantial risk of forfeiture.)

We note that there may be a number of technical issues under new Section 457A. See generally New York State Bar Assoc. Tax Section, Report on Proposed Carried Interest and Fee Deferral Legislation, pp. 100-113 (Sept. 24, 2008), 2008 TNT 87-42. Nevertheless, Section 457A is now a part of the Code, and will need to be addressed by those subject to it, including hedge funds and other investment funds using offshore entities and their managers.

IV. Conclusion

Fee-deferral arrangements can be a material aspect of the overall compensation of managers of hedge funds and other investment funds. New Section 457A may have a substantial impact on these arrangements in the case of funds using offshore entities, and funds and their managers may wish to address any effect that new Section 457A may have on them. White & Case stands ready to review potentially affected compensation arrangements and advise regarding issues that may arise under Section 457A.

White & Case

White & Case is a leading global law firm with more than 2,400 lawyers in 37 offices in 25 countries. Among the first US-based law firms to establish a truly global presence, we provide counsel and representation in virtually every area of law that affects cross-border business. Our clients value both the breadth of our network and depth of our US, English and local law capabilities in each of our offices and rely on us for their complex cross-border transactions, arbitration and litigation. Whether in established or emerging markets, the hallmark of White & Case is our complete dedication to the business priorities and legal needs of our clients.

Our approach is based on listening to our clients' needs, taking the time to understand their business and responding with effective strategies and solutions, no matter how big the opportunity or formidable the challenge. With new technologies, globalization, consolidation and other forces continuously changing how business gets done, we help our clients evaluate the risks and rewards of ventures designed to advance their interests.

We work with the world's most established and respected companies, including two-thirds of the *Global Fortune 100* and half of the *Fortune 500*, as well as with start-up visionaries, governments and state-owned entities.

This Client Alert is provided for your convenience and does not constitute legal advice. It is prepared for the general information of our clients and other interested persons. This Client Alert should not be acted upon in any specific situation without appropriate legal advice and it may include links to websites other than the White & Case website.

White & Case has no responsibility for any websites other than its own and does not endorse the information, content, presentation or accuracy, or make any warranty, express or implied, regarding any other website.

This Client Alert is protected by copyright. Material appearing herein may be reproduced or translated with appropriate credit.