

# SEWARD & KISSEL LLP

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## MEMORANDUM TO CLIENTS

### SUMMARY OF RULES CONTAINED IN NEW PROPOSED TREASURY REGULATIONS ON DEFERRED COMPENSATION ARRANGEMENTS OF INVESTMENT FUND MANAGERS

#### I. Introduction

Section 409A of the Internal Revenue Code (“Section 409A”) was enacted as part of the American Jobs Creation Act of 2004 (the “2004 Act”) and contains provisions relating to nonqualified deferred compensation plans, agreements and similar arrangements (“Deferred Compensation Plans”). Section 409A applies to the Deferred Compensation Plans entered into by U.S.-based investment managers (“Managers”) of offshore investment funds (“Offshore Funds”) with respect to the management fees and/or incentive fees payable to the Managers by the Offshore Funds. Section 409A also applies to the Deferred Compensation Plans entered into between Managers and their employees (and, possibly, the equity owners of the Managers). Proposed Treasury regulations were issued on September 29, 2005 (the “Proposed Regulations”) providing guidance on certain of the rules contained in Section 409A, including the types of plans and arrangements that are covered by Section 409A and the operational requirements for deferral elections and the timing of deferred compensation payments made under Section 409A. Section II of this memorandum summarizes the key aspects of the Proposed Regulations impacting the Deferred Compensation Plans entered into between Managers and Offshore Funds. We will distribute a more detailed memorandum analyzing the Proposed Regulations shortly.

The effective date for the final Treasury regulations under Section 409A is proposed to be January 1, 2007. Taxpayers may rely on the Proposed Regulations until final regulations under Section 409A are effective.

## II. Summary of Key Aspects of the Proposed Regulations Affecting Managers

The following are several key points of the Proposed Regulations relating to the typical Deferred Compensation Plans between Managers and Offshore Funds:

1. The deadline for documentary compliance with the new rules contained in Section 409A has been extended for one year from December 31, 2005 to December 31, 2006. This means that if a Deferred Compensation Plan is operated in good faith compliance with the provisions of Section 409A, a Manager and Offshore Fund have until December 31, 2006 to modify their existing Deferred Compensation Plan to comply with the provisions of Section 409A.

2. Section 409A generally requires that a deferral election be made no later than December 31 of the year preceding the year in which the relevant services are rendered or such other time as provided in Treasury Regulations. The Proposed Regulations in effect provide that a Manager of an Offshore Fund which has a fiscal year ending on a date other than December 31 can defer those incentive fees payable at the end of the fiscal year of the Offshore Fund provided that the Manager's deferral election is made prior to the commencement of the Offshore Fund's fiscal year. However, it appears that a Manager must make a deferral election by December 31 of the year preceding the commencement of the Offshore Fund's fiscal year in order to effectively defer (i) any incentive fees payable to the Manager with respect to the redemption of shares of the Offshore Fund during such fiscal year; and (ii) any management fees payable to the Manager with respect to such fiscal year.

3. Under the transitional rules contained in the Proposed Regulations, Section 409A applies to deferral elections made by a Manager prior to December 31, 2004 with respect to the fiscal year of an Offshore Fund ending after that date (i.e., a deferral election made by a Manager on or before June 30, 2004 with respect to the fiscal year of an Offshore Fund ending on June 30, 2005 is subject to rules contained in Section 409A). Therefore, Managers and Offshore Funds have until December 31, 2006 to modify the Deferred Compensation Plans that governed this prior deferral election to comply with the provisions of Section 409A. (However, under certain transitional rules, the fact that the deferral election was made prior to the beginning of the 2005 fiscal year, rather than prior to January 1, 2004, does not result in a violation of Section 409A.)

4. Section 409A in effect provides that if certain requirements are met, a Manager may elect to extend the deferral period with respect to a previously deferred fee. The Proposed Regulations do not impose any limitation on the number of times that a Manager can elect to extend previously made deferral elections. However, the Proposed Regulations do not appear to permit a Manager to extend the deferral period for fees that the Manager elected to defer prior to December 31, 2004 (since under the Proposed Regulations this would be viewed as a "material modification" of the pre-2005 arrangements and subject all aspects of those arrangements to the new rules).

5. Section 409A restricts the type of events that are permitted to trigger accelerated payment of deferred fees to a Manager. (For example, payment upon "separation from service" is permitted.) Under the Proposed Regulations, "back-to-back" deferral arrangements between a

Manager and its equity owners and employees and between the Managers and the Offshore Funds (i.e., arrangements whereby payments of all or portion of a Manager's fee deferrals with the Offshore Fund are accelerated upon an equity owner or an employee ceasing to provide services to the Manager) are expressly permitted for post-2004 fee deferrals provided that the deferred compensation arrangement between the Manager's equity owners and employees complies with all of the provisions contained in the 2004 Act. Therefore, to take advantage of the "back-to-back" rule, Managers should have written deferral arrangements with its equity owners and/or employees that also comply with Section 409A. However, we note that the Proposed Regulations reserve for future guidance any special rules relating to the applicability of Section 409A to the deferral of compensation by partners who provide services to partnerships. Therefore, until such future guidance is issued, it is unclear regarding how the "back-to-back" rule contained in the Proposed Regulations will be applied to the equity owners of those Managers treated as partnerships for federal income tax purposes.

Please contact Dan Murphy (212-574-1210) or Peter Pront (212-574-1221) of our Tax Group if you have any questions regarding this memorandum.

Seward & Kissel LLP

99999.0010 #605912