Seward & Kissel LLP

December 22, 2005

MEMORANDUM TO OUR CLIENTS

SUMMARY OF RECENT TREASURY DEPARTMENT GUIDANCE ON FEE DEFERRAL ARRANGEMENTS OF INVESTMENT FUND MANAGERS

I. Introduction

Section 409A of the Internal Revenue Code ("Section 409A") was enacted in October 2004 as part of the American Jobs Creation Act of 2004 (the "Act") and contains provisions significantly affecting the taxation of nonqualified deferred compensation plans, agreements and similar arrangements (collectively, "Deferred Compensation Plans" or "Plans"). Section 409A applies to the Deferred Compensation Plans entered into by U.S.-based investment managers ("Fund Managers") of offshore investment funds ("Offshore Funds") with respect to the management fees and/or incentive fees payable to them by the Offshore Funds (collectively, the "Fees"). Section 409A also applies to the Deferred Compensation Plans entered into between Fund Managers and their employees (and, possibly, the equity owners of the Fund Managers).

Among other provisions, Section 409A imposes certain requirements regarding deferral elections and permissible distributions from Deferred Compensation Plans. Unless all of these requirements are satisfied by a particular Deferred Compensation Plan,

(i) the compensation subject to a deferral election under the Plan will be taxable to the service provider in the taxable year in which the services were rendered,

(ii) interest at the tax underpayment rate plus one percentage point will be imposed on any underpayments attributable to the failure of the service provider to pay tax currently on the compensation, and

(iii) the taxable compensation will be subject to a 20 percent additional tax.

Proposed Treasury regulations were recently issued (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, the operational requirements for deferral elections and the timing of deferred compensation payments made under Section 409A. Section II of this memorandum summarizes the significant provisions of the Act and the Proposed Regulations affecting the Deferred Compensation Plans of Fund Managers. The Proposed Regulations do not, however, address all of the issues relating to the effect of the Act on such Deferred Compensation Plans and the Internal Revenue Service has announced that additional guidance relating to Section 409A will be issued in the near future.

As discussed more fully below, Fund Managers will have to review the terms of their existing Deferred Compensation Plans to determine whether any amendments need to be made thereto in order to comply with Section 409A. As discussed below, the Proposed Regulations generally permit Fund Managers to make such amendments any time before December 31, 2006 and be treated as in compliance with Section 409A for all taxable years subject to the Act. However, as discussed in Section II.E. below, certain Fund Managers may be required to amend their Deferred Compensation Plans by December 31, 2005 in order to comply with Section 409A.

II. Key Provisions of the Proposed Regulations

A. Effective Date of the Act

Section 409A generally is effective with respect to amounts deferred in taxable years beginning after December 31, 2004. Section 409A therefore generally does not apply to deferral elections made with respect to taxable years which end prior to 2005. However, Fees deferred in such pre-2005 taxable years will be subject to Section 409A if the provisions of the applicable Deferred Compensation Plan relating to such pre-2005 deferrals are materially modified after October 3, 2004.[1]

The Proposed Regulations provide that, for purposes of determining whether Section 409A is applicable with respect to a particular amount of compensation, the amount is considered deferred before January 1, 2005 if, before such date, the service recipient had a legally binding right to be paid the amount and the right to the amount was both earned and vested. Thus, with respect to Offshore Funds with a fiscal year ending on a date other than December 31, Section 409A applies to a deferral election made during 2004 by a Fund Manager with respect to an annual incentive fee payable with respect to a fiscal year of the Offshore Fund beginning in 2004 and ending in 2005 (because the incentive fee would not be "vested" until 2005).

Section 409A and the Proposed Regulations specifically treat earnings on deferred compensation as additional deferred compensation for purposes of Section 409A. Section 409A should therefore not have any application to the earnings attributable to pre-2005 deferrals that are not subject to Section 409A.

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[1] The Proposed Regulations generally provide that a modification of a plan is a "material modification" if a benefit or right existing as of October 3, 2004 is materially enhanced or a new material benefit or right is added, and such material enhancement or addition affects amounts earned and vested before January 1, 2005 (even though the enhanced or added benefit otherwise would be permitted under Section 409A with respect to post-2004 deferrals).

B. Distribution Events

Section 409A requires that a Deferred Compensation Plan provide that compensation deferred under the Plan "may not be distributed earlier than"[2]

1. "separation from service" (as determined by applicable Treasury Department guidance)[3],
2. serious disability likely to result in death or expected to last for 12 consecutive months,
3. death,
4. a specified time (or pursuant to a fixed schedule) specified under the Plan at the time the deferral election is made,
5. to the extent provided in Treasury Department guidance, a change in the ownership or effective control of the service recipient or in the ownership of a substantial portion of its assets, or
6. the occurrence of an "unforeseeable emergency" (provided that the distribution is limited to the amount necessary to satisfy the emergency). Thus, for example, Section 409A does not permit the acceleration of payments under circumstances where a substantial penalty (a "haircut") is imposed on the recipient as consideration for such acceleration.

(1) Separation from Service. Under the Proposed Regulations, an independent contractor (such as a Fund Manager) is considered to have a "separation from service" with the service recipient (such as an Offshore Fund) upon the expiration of all contracts under which services are performed for the service recipient if the expiration constitutes a good-faith and complete termination of the contractual relationship. Accordingly, the termination of the investment management agreement between a Fund Manager and an Offshore Fund generally should constitute a "separation from service" within the meaning of Section 409A.

The Proposed Regulations provide that an employee separates from service with the service recipient if the employee dies, retires or otherwise has a termination of employment with the employer. The employment relationship is treated as continuing intact while the individual is on military leave, sick leave, or other bona fide leave of absence if the period of leave does not exceed 6 months (or, if longer, so long as his right to reemployment with the service recipient is provided either by statute or contract). If the period of leave exceeds 6

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[2] The Proposed Regulations modify this requirement by providing that deferred compensation may be paid only "on account of" (in contrast to no "earlier than") the specified events.

[3] However, in the case of certain employees of corporations the stock of which is publicly traded, distributions may not be made prior to the date which is 6 months after the date of separation from service (or, if earlier, the date of death of the employee).

months and there is no statutory or contractual right to reemployment, the employment relationship is deemed to terminate on the first date immediately following such 6-month period.

(2) Designation of Payment Upon a Permissible Payment Event. A Deferred Compensation Plan may provide for payment upon the earliest or latest of more than one of the permissible payment events specified in the first paragraph of this subsection B. However, the Proposed Regulations do not appear to allow an arrangement where upon an employee's termination of employment the employer has the discretion to choose either to pay the deferred compensation to the employee currently or delay payment until the expiration of the previously designated deferral period.[4]

(3) When a Payment is Treated as Made. In general, a payment is treated as made upon the specified date if the payment is made at such date or a later date within the same calendar year or, if later, by the 15th day of the third calendar month following the specified date.

(4) "Back-to-Back" Arrangements. Section 409A does not expressly permit "back-to-back" deferral arrangements pursuant to which a Fund Manager's deferral election mirrors a deferral election made by employees or equity owners of the Fund Manager and permits a distribution of deferred fees by the Offshore Fund to the Fund Manager upon the employee or equity owner's ceasing to provide services to the Fund Manager.[5] However, under the Proposed Regulations, such "back-to-back" deferral arrangements generally are expressly permitted for post-2004 fee deferrals for employees provided that the deferred compensation arrangement between the Fund Manager and its employees complies with all of the provisions contained in Section 409A. Therefore, to take advantage of the "back-to-back" rule, Fund Managers must have written deferral arrangements with its employees that also comply with Section 409A.[6]

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

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[4] We do not see how allowing the employer to have such discretion in this situation is objectionable from a policy perspective, but nevertheless suggest that plans in which the employer has such discretion be amended.

[5] The pre-2005 deferral elections of some Fund Managers expressly provide for the creation of sub-accounts by the Offshore Fund for each individual employee or equity owner of the Fund Manager that makes a deferral election with the Fund Manager. Pursuant to such deferral election, if the electing employee or equity owner terminates his service with the Fund Manager for any reason prior to the deferral date specified by the Fund Manager in its deferral election, the Offshore Fund will distribute to the Fund Manager the deferred compensation attributable to the terminated employee or equity owner. Such an early distribution does not affect the deferral attributable to the remaining employees or equity owners.

[6] While Section 409A does not explicitly state that a Deferred Compensation Plan must be in writing, the Proposed Regulations provide that a Deferred Compensation Plan will comply with Section 409A only if it is set forth in writing.

is unclear regarding how the "back-to-back" rule contained in the Proposed Regulations will be applied to the equity owners of those Fund Managers treated as partnerships for federal income tax purposes. Until such clarifying guidance is issued, we recommend that (i) any "back-to-back" deferral elections relating to the equity owners of Fund Managers treated as partnerships for federal income tax purposes expressly provide that such elections are effective only to the extent permitted by such future guidance, and (ii) that Fund Managers utilizing such "back-to-back" arrangements have written agreements specifying when a departing equity owner's share of deferred fees are to be paid to him.

(5) Prohibition on Acceleration of Payments. Section 409A provides that a Deferred Compensation Plan must not permit the acceleration of the time or schedule of any payment under the Plan, except as provided in Treasury Regulations. The Proposed Regulations allow a Deferred Compensation Plan to permit the acceleration of payments under the Plan (i) to pay FICA taxes imposed on the deferred compensation, and (ii) at any time the Plan fails to meet the requirements of Section 409A and the Proposed Regulations, but only to the extent of the amount required to be included in income as a result of such failure. In certain limited instances, a service recipient may terminate a Deferred Compensation Plan without violating the anti-acceleration provision of Section 409A.

(6) Management Fees Payable on "Side Pocket" Investments. Where a domestic investment partnership or an Offshore Fund holds its illiquid investments in separate accounts ("side pockets"), an investor's interests in such investments generally are not redeemable until the investment fund disposes of the investment or is deemed to dispose of the investment. If an investor withdraws from an investment fund which has "side pocket" investments, the management fees payable by the investor with respect to such investments often are accrued and paid upon the fund's subsequent disposition or deemed disposition of the investment. Such an accrual of management fees appears to constitute "deferred compensation" which is subject to the rules of Section 409A. Since the actual or deemed disposition of an illiquid investment is not a permissible distribution event under Section 409A, the accrual of management fees owed with respect to such investments by a former investor in the fund would appear to violate Section 409A. *Fund Managers of domestic investment partnerships and Offshore Funds which utilize "side pocket" investments should consult us regarding the alternative approaches which may be utilized to avoid the possibility of such tax consequences.*

(7) Nondeferred Incentive Fees. The investment management agreements of many Fund Managers provide that a specified percentage of any incentive fees with respect to a fiscal year that are not deferred by the Fund Managers is payable at the beginning of the next fiscal year and the remainder of the fee is payable upon completion of the Offshore Fund's audit for the first fiscal year. Since the final payment of the incentive fee is dependent upon the happening of a specified event (i.e., the completion of the Fund's audit), rather than a fixed date, if such final payment occurs more than 75 days following the end of the fiscal year, it appears that this final payment may constitute "deferred compensation" that would not satisfy the distribution requirements of Section 409A and thereby subject the Fund Manager to the risk of the adverse tax consequences set forth above. To eliminate any such risk, we recommend that Fund Managers amend their investment management agreements to provide that any incentive fees that are not subject to a deferral election be required to be paid on a specified date after the end of the fiscal year involved (for example, "within 120 days after the end of the fiscal year").

C. **Timing of Deferral Elections**

(1) General Rule. Section 409A requires a Plan to provide that a service provider's deferral election must be made no later than the close of the taxable year (which for this purpose means the calendar year) that precedes the taxable year in which the services are rendered or at such other time as provided in Treasury Regulations.

(2) Offshore Funds with Fiscal Years Other Than December 31. The Proposed Regulations provide that in the case of a service recipient with a fiscal year other than the calendar year (e.g., an Offshore Fund), a Plan may provide that "fiscal year compensation" may be deferred at the service provider's election only if the deferral election is made no later than the close of the service recipient's fiscal year next preceding the first fiscal year in which any services for which such compensation is payable are performed. "Fiscal year compensation" means compensation relating to a period of service coextensive with one or more consecutive fiscal years of the service recipient, of which no amount is paid or payable during the service period.

Thus, except as provided below, the Proposed Regulations effectively provide that a Fund Manager of an Offshore Fund that has a fiscal year ending on a date other than December 31 (for example, June 30) can defer those annual incentive fees payable at the end of the Offshore Fund's fiscal year provided that the Fund Manager's deferral election is made prior to the commencement of the Offshore Fund's fiscal year. However, it appears that a Fund 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 Fund Manager with respect to the redemption of shares of the Offshore Fund during such fiscal year;*

(ii) *any incentive fees payable to the Fund Manager with respect to shares of the Offshore Fund that are purchased during such fiscal year; and*

(iii) *any management* fees *payable to the Fund Manager with respect to such fiscal year.*

Further, if an employee of a Fund Manager is entitled to receive a bonus equal to a portion of the incentive fees payable to the Fund Manager with respect to an Offshore Fund that has a fiscal year ending on a date other than December 31, then, unless such bonus qualifies as "performance-based compensation" (as discussed below), it appears that any deferral election to be made by such employee must be made by December 31 of the year preceding the commencement of the Offshore Fund's fiscal year (because the fiscal year of the service recipient (the Fund Manager) is the calendar year).

(3) First Year of Eligibility. Section 409A provides that in the case of the first year in which a participant becomes eligible to participate in a Deferred Compensation Plan, the participant may make a deferral election with respect to compensation attributable to services

performed subsequent to the election provided that the election is made within 30 days after the date the participant becomes eligible to participate in such plan.

(4) "Performance-Based Compensation". Section 409A provides a special election timing rule with respect to "performance-based compensation" that is more favorable than prior law. Section 409A provides that where "performance-based compensation" is earned for services performed over at least a 12-month period, the deferral election relating to such compensation may be made no later than 6 months before the end of the performance period.[7]

While we believe that an "incentive fee" based on the annual investment performance of the Offshore Fund should constitute "performance-based compensation" that is eligible for this special extended election period, our view is that this extended period would be unavailable with respect to both (i) the incentive fee attributable to Offshore Fund shares that are redeemed during a particular year, and (ii) the incentive fee attributable to Offshore Fund shares that are purchased during a particular year; (since the measurement of the incentive fee in either situation would not be based on a period of at least 12 months).

(5) Non-Elective Arrangements. An arrangement that provides for a deferral of compensation that does not provide the service provider with an opportunity to elect the time of payment of such compensation (e.g., a deferral of compensation required by the service recipient) must specify the future time of payment of the deferred compensation no later than the time the service provider first has a legally binding right to the compensation.

D. Subsequent Deferral Elections

Section 409A permits a participant in a Deferred Compensation Plan who has made a prior deferral election to make a subsequent election to either delay the time of the payment of the previously deferred amount or to change the form of such payment (a "Subsequent Deferral Election"), provided that

(i) the Subsequent Deferral Election takes effect at least 12 months after the date on which the election is made;

(ii) except in the case of elections relating to death, disability or unforeseeable emergency, the payment with respect to which the Subsequent Deferral

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[7] The Proposed Regulations define "performance-based compensation" as compensation where the amount of, or entitlement to, the compensation is contingent on the satisfaction of pre-established organizational or individual performance criteria relating to a performance period of at least twelve consecutive months in which the service provider performs services. Organizational or individual performance criteria are considered pre-established if established in writing no later than 90 days after the commencement of the related service period, provided that the outcome is substantially uncertain at the time the criteria are established. "Performance-based compensation" does not include any amount (or portion of an amount) that will be paid regardless of performance or based upon a level of performance that is substantially certain to be met at the time the criteria is established. In certain instances, payments based upon subjective performance criteria may constitute "performance-based compensation".

Election is made is deferred for a period of not less than 5 years from the date such payment would otherwise have been made (or in the case of certain installment payments, 5 years from the date the first amount was scheduled to be paid); and

(iii) any Subsequent Deferral Election related to a payment deferred to a specific time may not be made less than 12 months prior to the date the payment is scheduled to be paid (or in the case of certain installment payments, 12 months prior to the date the first amount was scheduled to be paid).

For these purposes, a "payment" generally refers to each separately identified amount to which a service provider is entitled to payment under a plan on a determinable date. An amount is separately identified only if it may be objectively determined (e.g., 10% of the account balance as of a specified payment date).

Neither Section 409A nor the Proposed Regulations limit the number of Subsequent Deferral Elections that are permitted to be made under the new rules described above. Further, as long as the Deferred Compensation Plan satisfies all of the requirements specified above, Subsequent Deferral Elections may be made even if the initial deferral period was less than 5 years.

Where the Deferred Compensation Plan of a Fund Manager did not permit Subsequent Deferral Elections for years prior to 2005 ("Pre-2005 Years"), the amendment of such a Deferred Compensation Plan after October 3, 2004 to add such a right with respect to amounts that were deferred with respect to Pre-2005 years should constitute a "material modification" of the Deferred Compensation Plan. The Deferred Compensation Plan would therefore lose its "grandfathered" status and be subject to the rules of Section 409A for all of the years of its existence. In our view, the Proposed Regulations do not clearly permit such a Fund Manager to utilize the transition relief discussed in Subsection E below to amend the Deferred Compensation Plan so as to fully satisfy Section 409A with respect to such Pre-2005 years and to avoid any adverse tax consequences by reason of such a "material modification." Given the potentially significant tax consequences of subjecting the Deferred Compensation Plan to Section 409A with respect to all Pre-2005 years, we do not recommend that such Fund Managers amend their Deferred Compensation Plans to expressly add a Subsequent Deferred Election feature with respect to pre-2004 deferrals until the Internal Revenue Service provides further guidance on this issue.

However, we believe a Fund Manager whose Deferred Compensation Plan prior to the Act expressly permitted Subsequent Deferral Elections should be permitted to make Subsequent Deferral Elections with respect to pre-2004 deferrals without affecting the applicability of the Act to such pre-2004 deferrals (because no "material modification" of the Fund Manager's Deferred Compensation Plan should result in this situation).

E. **Transition Relief**

Except as provided below, the Proposed Regulations have extended the deadline for documentary compliance with the new rules contained in Section 409A 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 prior to December 31, 2006, a Fund Manager and Offshore Fund generally will have until such date to modify their existing Deferred Compensation Plan to comply with the provisions of Section 409A without subjecting any post-2004 Fee deferral elections made by the Fund Manager to Section 409A.

However, the Proposed Regulations are not entirely clear regarding the applicability of the extended compliance deadline, to a Deferred Compensation Plan

(i) involving an Offshore Fund with respect to a fiscal year ending on a date other than December 31 where the Fund Manager elected to defer fees for the fiscal year of the Offshore Fund which began in 2004 and ended in 2005, or

(ii) a Fund Manager who made a deferral election with respect to services rendered in 2005 after December 31, 2004.

We therefore recommend that such a Deferred Compensation Plan be amended to comply with Section 409A prior to December 31, 2005 in order to avoid the risk of the imposition of any adverse tax consequences on the Plan's participants).

A Deferred Compensation Plan may be amended to provide for new elections on or before December 31, 2006 with respect to the time of payments of amounts subject to Section 409A, provided that (i) the Plan is so amended and the service provider makes the election on or before December 31, 2006, and (ii) the amendment and election applies only to amounts that would not otherwise be payable in 2006 and does not cause an amount to be paid in 2006 that would not otherwise be payable in 2006.

A Deferred Compensation Plan may be amended prior to December 31, 2005 to allow a participant to cancel a deferral election with respect to amounts subject to Section 409A provided that the amounts subject to the cancellation are includible in income in the 2005 calendar year or, if later, the year in which the amounts are earned and vested.[8] An example of a situation where such a cancellation should be made is the case where a Fund Manager made an election in June 2005 to defer fixed fees attributable to services rendered in the third and fourth calendar quarters of 2005.

F. Provisions of the Act Not Addressed in the Proposed Regulations

1. Offshore Funding

Section 409A generally provides for the current taxation of any compensation subject to a deferral election if assets are located or transferred outside of the United States are

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[8] For this purpose, the cancellation of an election includes a cancellation that results in a lower amount of deferrals for the period, without a complete elimination of the deferrals.

"set aside in a trust (or other arrangement determined by the [Treasury Department]."[9] Based on the legislative history of the Act, it appears that this provision was intended to specifically apply to "offshore rabbi trusts" and similar arrangements where an employer "sets aside" or segregates a portion of its assets pursuant to a specific arrangement. Subject to further analysis after the issuance of future Treasury guidance in this issue,[10] we believe that this special taxation rule should not apply where an Offshore Fund holds all or a portion of its assets with a foreign prime broker for valid business reasons and does not segregate any of such assets in a separate arrangement for the benefit of the Fund Manager.

The Proposed Regulations provide no further guidance with respect to the offshore funding provisions of Section 409A. The Internal Revenue Service has informally indicated that such guidance should be forthcoming in the near future.

2. New Reporting Provisions

The Act imposes new reporting and federal income tax withholding requirements with respect to amounts required to be included in income under the Act. The Act requires annual reporting to the Internal Revenue Service of "amounts deferred" under Deferred Compensation Plans.[11] Such amounts are required to be reported on a service provider's IRS Form W-2 or Form 1099 for the year deferred even if the amount is not currently taxable in that taxable year. The information reporting requirements are effective for amounts actually deferred in calendar years beginning after December 31, 2004 (and income attributable to such amounts).[12] The instructions for Form W-2 and Form W-9MISC provide information regarding the reporting requirement.

The Act does not specifically address the extent, if any, to which the new reporting rules are applicable to the deferred compensation of entities treated as partnerships (including limited liability companies) and their partners (or members) who receive a Schedule K-1 from the partnership, rather than a Form W-2 or Form 1099. The Proposed Regulations did not provide any guidance on the Act's new reporting rules. However, the

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9 This rule does not, however, apply to assets located outside the United States if substantially all of the services to which the deferred compensation relates are performed in the jurisdiction where the assets are held.

10 The Act expressly authorizes the Treasury Department to issue regulations exempting from the Act arrangements that will not result in an "improper deferral" of United States taxes and will not result in assets being effectively beyond the reach of an employer's creditors.

11 The legislative history of the Act reflects Congressional expectation that this annual reporting of deferred amounts will provide the Internal Revenue Service with greater information regarding such arrangements so as to provide an indication of what arrangements should be examined and challenged.

12 For this purpose, an amount is considered to be "actually deferred" at the time the service provider has a legally binding right to the compensation (even though such amount may not yet be vested).

Internal Revenue Service has recently announced the suspension of the new reporting and withholding obligations described above for the calendar year ended 2005. The Internal Revenue Service expects to issue additional reporting and withholding guidance relating to Deferred Compensation Plans during the first half of 2006.

We suggest that Fund Managers review any Deferred Compensation Plans that they may have, whether with Offshore Funds or with their employees, and contact us to discuss the changes, if any, that should be made to such Deferred Compensation Plans and the timing for making such changes.

If you have any questions regarding this Memorandum, please contact Daniel Murphy (212-574-1210) or Peter Pront (212-574-1221) of our Tax Group or the partner in our Investment Management Group who handles your account.

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