



The Tax Practice of Sidley Austin LLP

Our Tax Practice provides legal services in transactions, planning and controversy related to United States federal, state and local and United Kingdom tax laws. Our lawyers work closely with our clients and with lawyers in the firm's other practice groups to develop timely, cost-effective tax strategies and to identify and solve potential tax-related problems.

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Application of Section 457A to Side Pocket or Illiquid Investments

Summary

Taxpayers that have compensation arrangements with offshore funds (or certain other tax indifferent persons) ("nonqualified entities") that hold side pocket or illiquid investments (directly or through a master fund) should consider whether such compensation arrangements are affected by a recently enacted tax provision. Affected taxpayers should consider restructuring their compensation arrangements in a manner that is not subject to the application of this provision. Any such restructuring must be completed by December 31, 2008 to be effective for 2009.

Discussion

Internal Revenue Code Section 457A, passed by Congress as part of the TARP financial rescue legislation, is aimed at the hedge fund industry. Its primary purpose is to eliminate the ability of managers to enter into deferred compensation arrangements with nonqualified entities. Section 457A is effective for compensation earned after December 31, 2008. Section 457A applies to both cash and accrual method taxpayers.

In addition to traditional deferred compensation plans, the legislation also affects most compensation arrangements with nonqualified entities that hold side pocket or illiquid investments (either directly or through a master fund). Very generally, Section 457A imposes a 20% penalty, as well as interest charges, on any portion of an incentive fee that is determined with respect to realized profits on a particular asset (as opposed to a fee that is taken into account annually based on mark-to-market appreciation).

We are advising clients that have incentive fee arrangements (as opposed to incentive allocation arrangements) with funds that have (or may have) side pocket or illiquid investments to consider restructuring their compensation arrangements in a manner that would not be subject to the application of Section 457A. The restructuring involves converting the existing offshore fund structure to a structure similar to the domestic fund structure where the investment adviser is entitled to a profit allocation or, alternatively, where the offshore fund's only investment is an investment in a master fund classified as a partnership for U.S. federal income tax purposes, to eliminate the

performance fee at the offshore fund level and provide for a profit allocation at the master fund level. Profit allocations currently are not subject to Section 457A. The restructuring should be done so as to be effective as of the beginning of a taxable year. Thus, managers that want to avoid Section 457A issues with respect to side pocket or illiquid investments for the calendar year 2009 should complete the restructuring before January 1, 2009.

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