

Legal Update

Hedge Fund Tax Alert: 2011 Deferral Election Deadline, and Special Issues for Re-Deferring Before 2017

September 2011

As detailed in our [prior alert](#), Section 457A of the Internal Revenue Code generally prevents hedge fund managers from deferring fees earned after 2008. Pre-2009 deferrals were grandfathered from the application of this rule, but are generally subject to tax no later than 2017.

Hedge fund managers should consider the following issues relating to grandfathered deferrals.

2011 Deadline for Accelerating Certain Grandfathered Deferrals. Grandfathered deferrals will generally be taxed during 2017, even if they are payable in a later year. Section 409A of the Internal Revenue Code generally prohibits accelerating the payment of deferrals, which could present cashflow and other problems for managers who are taxed in 2017 on deferrals that are payable in later years. Notwithstanding Section 409A, deferrals taxed during 2017 under the Section 457A legislation may be accelerated to be paid in 2017, provided that the acceleration is documented and binding no later than December 31, 2011. If you have any deferrals due after 2017, you need to act by December 31, 2011.

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Special Issues for Deferrals Payable During 2013, 2014, 2015 or 2016. There are potential issues with re-deferring amounts scheduled to be paid during 2013, 2014, 2015 or 2016. Section 409A(a) requires re-deferrals to be at least 5 years, which would push the payment of such deferrals past 2017 (when they will be taxed under Section 457A). The Section 457A legislation appears to provide relief from this issue, as it directs the Treasury Department to provide an exception from Section 409A(a) (which includes the “5 year deferral rule”). Under this legislation, it should be possible for a deferral due (for example) in 2015 to be effectively re-deferred to 2017, when it will be subject to tax.

However, the Treasury Department (through Notice 2009-8, Q&A 25) appears to have provided relief that is more limited than the legislation requires. Based on this Notice and informal discussions with the IRS, we understand the IRS’s position to be that (for example) re-deferring a deferral due in 2015 to 2017 would violate the Section 409A 5 year deferral rule. We believe that this position is incorrect. However, taking a contrary position would involve significant risk (i.e. potentially nullification of the re-deferral and a 20% penalty imposed on the amount re-deferred).

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