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ERISA Basics and Tax Considerations in Three Areas Important to Corporate Lawyers

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I. INTRODUCTION

There are certain employee benefit plan-related matters that should be reviewed from time to time by corporate attorneys. Three such matters that continue to present design and compliance challenges to attorneys with a corporate practice deal with equity investments by plan investors, equity programs established by partnerships and LLCs and deferred compensation arrangements.

II. EQUITY INVESTMENTS BY PLAN INVESTORS

A. ERISA PLAN ASSET REGULATIONS

1. Applicability and Look-Through Rule

Regulations issued by the United States Department of Labor (the "DOL") as 29 CFR 2510.3-101 under the Employee Retirement Security Act of 1974, as amended ("ERISA") defining ERISA plan assets with respect to plan investments (the "Plan Asset Regulations") generally provide that certain investments by an employee benefit plan in the equity of an entity include not only the interest in the entity, but also an undivided interest in the entity's underlying assets (the "Look-Through Rule"), which could, depending on how the entity is structured and is managed, result in a myriad of ERISA compliance issues. The plans to which the Plan Asset Regulations apply are employee benefit plans subject to ERISA and any plan, such as an IRA, that is subject to the prohibited transaction rules contained in Section 4975 of the Internal Revenue Code of 1986, as amended (the "Code"). The Plan Asset Regulations can apply to collective investment arrangements established to invest funds, such as a hedge fund, and look-through the entity to regulate the manner in which the underlying assets are held and managed. The Look-Through Rule applies only to certain equity investments, as described below, by an employee benefit plan, but not to investments in debt instruments.

2. Exceptions

The Plan Asset Regulations and the Look-Through Rule established thereunder do not apply to equity investments by employee benefit plans in securities issued by registered investment companies, publicly offered securities or operating companies, including venture capital operating companies and real estate operating companies as described in the Plan Asset Regulations. The Plan Asset Rules also do not apply to investments in an entity in which less than 25% of the value of any class of equity interests in the entity (excluding certain interests held by controlling persons), determined immediately after the most recent acquisition of any equity interests in the entity (for this purpose, the DOL takes the position that a redemption of an interest in the entity is treated as an acquisition by the remaining investors), are held by benefit plan investors. This 25% investment exception is the most widely used exception to the application of the Plan Asset Regulation.

B. FUND DISCLOSURES TO INVESTORS

Disclosures regarding the Plan Asset Regulations, ERISA, tax and fiduciary considerations are generally made by investment funds to prospective benefit plans investors in various sections of the fund's private placement memorandum. The disclosures could be included in sections entitled ERISA Considerations, Tax Matters or Risk Factors depending on how the private placement memorandum is prepared. Subscription documents also may include disclosures and acknowledgements relating to these matters, as well as certain ERISA and tax-related representations by the benefit plan investors.

C. ERISA ISSUES

If the assets of an entity in which employee benefit plan invest are treated as ERISA plan assets, the person or persons with discretion to manage the entity and its assets, such as an investment manager or general partner, will be considered a fiduciary under ERISA with respect to each ERISA benefit plan investor and subject to the prohibited transaction rules of Section 406 of ERISA and Section 4975 of the Code, which could create certain fiduciary liability issues (including restoration of losses and return of profits), as well as excise tax liability for such persons, including by reason of transactions involving the entity's assets and the compensation arrangements applicable to such persons. Also, under ERISA, the indicia of ownership of ERISA assets generally are required to be held within the jurisdiction of U.S. courts, which could create a problem for an investment fund with international investments. Depending on the circumstances of a particular fund and the concerns of a benefit plan investor, the benefit plan investor may request a side letter with the fund establishing certain rights in favor of the investor. A plan investor is required to file an annual report for the plan on Form 5500 that includes, among other things, information regarding the value of each of the plan's assets and fees paid by the plan to service providers and this information may be difficult to obtain in connection with investments in private funds.

D. TAX CONSIDERATIONS FOR IRA INVESTORS

IRAs are considered benefit plan investors under the Plan Asset Regulations and as a result, are included in determining whether investments by benefit plan investors in an entity exceed 25%. However, IRAs are not subject to ERISA and the grantor of an IRA or other person dealing with the assets of an IRA would not incur liability under ERISA as a result of the investments of an IRA. IRAs are, however, subject to the prohibited transaction rules of Section 4975 of the Code and Section 408(e)(2) of the Code provides that if an investment in an entity by an IRA constitutes a prohibited transaction under Section 4975 of the Code, the IRA loses its tax exempt status as of the first day of the year in which the prohibited transaction occurs. For that reason and the lack of regulatory guidance regarding certain "self-dealing" type prohibited transactions under Section 4975 of the Code, if there is any possibility that an investment by an IRA might be viewed as a prohibited transaction (such as an investment that might benefit the IRA grantor individually, for example, by assisting an IRA grantor's individual investment in a fund satisfy the fund's minimum subscription requirement), the IRA grantor should consider splitting the IRA into two separate IRAs to isolate the potentially problematic investment from the other IRA assets and minimize the potential adverse tax consequences associated with the investment in the fund. In addition to the tax issues described above, the actual rate of return on an investment by an IRA (as well as any other benefit plan investor) may be reduced if the investment fund generates unrelated business taxable income as described in Sections 511 through 514 of the Code.

III. EQUITY AND EQUITY-BASED INCENTIVE COMPENSATION PROGRAMS FOR PARTNERSHIPS AND LLCs

A. INTRODUCTION

In recent years, partnerships and limited liability companies taxed as partnerships (referred to collectively in this outline as "partnerships") have become popular forms of structuring business entities. The popularity of partnerships as a form of doing business relates to a variety of tax and governance advantages, but creates certain challenges with respect to providing equity compensation to persons providing services to a partnership (referred to collectively in this section of the outline as "employees"). It should be noted that the tax consequences associated with the transfer of a partnership interest in connection with the performance of services continues to develop, based primarily on the status of guidance from the Internal Revenue Service. This outline describes certain advantages and disadvantages of the most common forms of partnership equity and equity-based compensation programs.

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