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Possible Offshore Deferrals for Hedge Fund Managers – IRS Confirms That Certain Stock Options and Stock Appreciation Rights Are Exempt Under Section 457A

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The Internal Revenue Service (the "IRS") has issued Revenue Ruling 2014-18 (the "Ruling")[1], which generally confirms that a stock-settled stock option or stock appreciation right that is granted with an exercise/base price of no less than the fair market value of the underlying stock on the date of grant will not be considered "nonqualified deferred compensation" subject to Section 457A of the Internal Revenue Code of 1986, as amended.[2] Section 457A effectively ended the practice of offshore hedge fund fee deferrals.

Section 457A

Section 457A generally provides that any compensation that is deferred under a "nonqualified deferred compensation plan" of a "nonqualified entity" is includible in gross income when there is no substantial risk of forfeiture of the rights to such compensation. Under Section 457A, the term "nonqualified deferred compensation plan" generally includes any plan or arrangement pursuant to which a service provider has a legally binding right to compensation during a taxable year that is or may be payable to the service provider in a later taxable year. A "nonqualified entity" is generally defined as (i) any foreign corporation unless substantially all of its income (i.e., at least 80%) is (a) effectively connected with the conduct of a trade or business in the US, or (b) subject to a comprehensive foreign income tax, or (ii) any partnership (domestic or foreign) unless substantially all of its income (i.e., at least 80%) is allocated to persons other than (a) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and (b) tax exempt organizations.

In addition, if the amount of such compensation is "not determinable" at the time that such compensation is required to be includible in income under Section 457A, then such compensation will be includible in income when determinable and will be subject to a 20% additional penalty tax and imputed interest (at the underpayment rate plus 1%) as if such compensation had been includible in income as of the time the income was not subject to a substantial risk of forfeiture.[3]

Section 457A's enactment effectively ended the practice of offshore hedge fund fee deferral arrangements (other than with respect to certain grandfathered arrangements and arrangements that include service-based risk of forfeiture) as the payors under such arrangements typically qualified as "nonqualified entities" and the arrangements themselves typically qualified as "nonqualified deferred compensation plans." Further, to the extent these arrangements were structured in a manner so that the amount of compensation includible in income was "not determinable" at the requisite time, Section 457A's punitive tax consequences would apply. Accordingly, most offshore hedge fund managers were forced to receive their performance compensation either in the form of a partnership allocation (since profits interests are generally exempt from Section 457A) or on an annual basis, based on annual performance (as opposed to receiving such fees later in the life of the fund based on a multi-year performance period).

Of relevance to the Ruling, Section 457A specifically provides that the term "nonqualified deferred compensation plan" includes ***any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient***. Such language would clearly include most stock options and stock appreciation rights, as such arrangements typically provide for a right to compensation that is based on the appreciation in value of a set number of shares of the underlying stock in excess of a pre-established exercise/base price.

However, in the Ruling, the IRS confirmed its position that stock options and stock appreciation rights (each, a "stock right") will not constitute "nonqualified deferred compensation" for purposes of Section 457A if structured in the manner described below.

Summary of the Ruling

The Ruling generally provides that a stock right will not constitute "nonqualified deferred compensation" for purposes of Section 457A if:

the stock right's terms provide that it must be settled, and it is in fact settled, in "service recipient stock" (i.e., cash-settled stock rights are subject to Section 457A);

- the exercise/base price of the stock right is at all times not less than the fair market value of the underlying stock on the date of grant of the stock right;
- the stock right does not otherwise provide any feature for the deferral of compensation (e.g., any right that would allow for the deferral of compensation beyond the date of exercise/settlement);
- the stock right is granted with respect to a fixed number of shares of service recipient stock; and
- upon acquiring the service recipient stock pursuant to the exercise/settlement of the stock right, the service provider will have the same redemption rights with respect to such stock as the other shareholders.

What Hedge Fund Managers Need to Know

The important question is how useful will such stock rights really be as a form of deferred compensation for managers of offshore hedge funds. The following are some items to note in regards to the potential utility of stock rights for such purposes (some of which may prove to be non-issues or mere administrative burdens, while others may be non-starters from a tax, legal or business perspective):

1. A new stock right would need to be granted each time a new or existing investor acquired shares in the fund with respect to a percentage of the shares acquired by the investor at such time.
2. Each stock right would need to be structured in such a manner so that it is exempt from Section 457A, and the manager's stock rights (collectively) should provide that the manager would not receive a greater amount of compensation (for example, taking into account any hurdle) than it otherwise would receive in the absence of Section 457A restrictions. Upon exercise/settlement of the stock right, this typically would result in the manager having to include as ordinary income the "spread" between the exercise/base price of such stock right and the fair market value of the stock on the date of exercise/settlement.

3. The manager's compensation would be based on the aggregate performance of the fund during the period from the date of grant through the date of exercise/settlement, rather than being based on annual performance as is currently typical.
4. Since the exercise/base price of the stock right must at all times be no less than the fair market value of the underlying stock on the date of grant of the stock right, the fund's valuation procedures (which presumably would be used for determining such fair market value) may be subject to increased IRS scrutiny.
5. Gain from the sale of the underlying shares, as well as distributions with respect to those shares, may be subject to adverse tax treatment under the "passive foreign investment company" ("PFIC") rules, which could negate much of the anticipated tax benefit.

Given the punitive tax consequences that would apply in the case of noncompliance with Section 457A (and the other potential legal, tax and business considerations and restrictions noted above), extreme care should be taken in structuring and implementing any such stock rights. We would be happy to assist and advise you with respect to such matters.

If you have any questions regarding the Ruling or this client alert, please feel free to contact any of the Proskauer attorneys listed in this alert.

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This publication is a service to our clients and friends. It is designed only to give general information on the developments actually covered. It is not intended to be a comprehensive summary of recent developments in the law, treat exhaustively the subjects covered, provide legal advice, or render a legal opinion.

[1] The Ruling is available here.

[2] Although this confirmation is welcome, the IRS' position in the Ruling is consistent with its position taken in IRS Notice 2009-8, Q/A 2(b), which is available here.

[3] For a more detailed summary of Section 457A and IRS Notice 2009-8, please see our prior client alert available here.

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