Code Section 457A Revisited: Permitted Offshore Deferrals for Investment Fund Managers

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Although formal guidance under Section 457A of the Internal Revenue Code of 1986, as amended (the "***Code***") has been limited since its enactment, the Internal Revenue Service (the "***IRS***") recently issued guidance that may open the pathway for permitting investment fund managers to defer the compensation paid from certain investment funds and to better align their interests with the investors in their funds.

Elimination of Deferrals; Misalignment of Interests Between the Fund Manager and Investor

Section 457A of the Code ("***Section 457A***") was enacted by Congress in 2008 as a part of the Emergency Economic Stabilization Act of 2008 (commonly referred to as the "bailout" bill).[1] At the time, there was a perception that U.S. hedge fund managers were deferring substantial amounts of income offshore without subjecting such income to U.S. taxation. Section 457A was enacted as a measure to curb such "abuse" by hedge fund managers.[2]

As a general matter, when compensation is paid by U.S. service recipients, at the time such compensation is taken into income by the service provider, the service recipient is entitled to a corresponding tax deduction.[3] When the service provider defers receipt of such compensation, the service recipient loses the immediate ability to take a tax deduction and must wait until the compensation is paid. However, when the service recipient is not subject to a comprehensive tax system or is otherwise "tax-indifferent" (such is often the case with offshore hedge funds or funds predominately held by tax-exempt organizations), the service recipient has no inherent interest in taking a tax deduction (as there is no or little tax to pay) and paying the compensation. To create the incentive of paying such compensation, Congress passed Section 457A. Although the actual statute that was passed into law was much broader in its application, the law effectively accomplished its purpose of limiting deferrals of compensation payable to U.S. hedge fund managers by such offshore investment fund and other "tax-indifferent" service recipients.

Section 457A effectively accomplishes its purpose by including amounts in the service provider's income when such amounts are no longer subject to a substantial risk of forfeiture (i.e., when the right to the compensation "vests").[4] Under Section 457A, any compensation deferred under a "nonqualified deferred compensation plan" of a "nonqualified entity" is includable in gross income and taxable when there is no substantial risk of forfeiture to the rights to the compensation.[5] A "nonqualified entity" includes (i) a foreign corporation where substantially all of its income is not effectively connected with the conduct of a trade or business in the U.S. or where it is not subject to a comprehensive foreign income tax, and (ii) any partnership where substantially all of its income is allocated to foreign persons who are not subject to a comprehensive foreign income tax or to organizations that are exempt from U.S. income tax.[6] In short, the compensation payable by entities in tax-haven jurisdictions and partnerships with foreign or tax-

[1] Pub. L. No. 110-343 (Oct. 3, 2008).

[2] For purposes of this article, the term "fund manager" is used to refer to the person providing investment management services to the investment fund, and interchangeably to mean the party establishing the investment fund as well.

[3] *See* Code § 162.

[4] Code § 457A(a). In cases where the compensation is not determinable, the amounts can be paid later than the date such amounts are no longer subject to a substantial risk of forfeiture, but such amounts will be subject to substantial penalty taxes. *Id.* at § 457A(c).

[5] Code § 457A(a). Under Section 457A, an amount is subject to a "substantial risk of forfeiture" only if the service provider's right to such amount is conditioned on the performance of future services by such service provider. *Id.* at § 457A(d)(1)(A).

[6] *Id.* at § 457A(b).

exempt partners will be taxed upon vesting, even if it has not been paid to the service provider, unless those entities (or partners of those entities) are otherwise subject to tax. Unlike Section 409A of the Code ("***Section 409A***"), which permits the deferral of compensation so long as it complies with the requirements of Section 409A, compensation that is subject to Section 457A simply may not be deferred at all.

Historically, U.S. hedge fund managers have charged the investments funds under their management a management fee based on assets under management and an incentive fee based on gains and returns on investments. Prior to Section 457A, fund managers routinely deferred the receipt of the incentive fee compensation payable from offshore hedge funds for a variety of reasons and often reinvested such amounts in the investment funds they managed. For the fund manager, this deferral had the advantage of tax-free growth and delayed taxes. From the investor's perspective, the fund manager was truly in a "partnership" with the investor by investing in the same investment fund as the investors – i.e., the fund managers had "skin in the game." By having such amounts invested along with the investors, the interests of the fund managers and the investors were aligned, and if the fund didn't perform well going forward, there was an intrinsic "clawback" of the performance compensation.

A consequential effect of curtailing the deferral of compensation was that the investors in such offshore investment funds lost such advantages. Because fund managers are effectively paid on an annual basis under a post-Section 457A regime with limited ability to structure multi-year incentive compensation arrangements, in highly profitable years, the fund manager could receive the full incentive compensation, with lesser risk of a clawback of such compensation in any subsequent poorly performing years. This misalignment of interests can be illustrated with the following basic example:

> Tax-Exempt Investor acquires 1,000 equity units of Offshore Fund at a net asset value (NAV) price of $1,000 per unit. The fund manager receives a 20% incentive fee that is payable on an annual basis. After year 1, the NAV per unit rises up to $2,000 per unit, but then after year 2, it drops to $1,800 per unit, and then after year 3, drops further to $1,500 per unit. Following year 1, an incentive fee of $200,000 would be paid [20% of the appreciation of $1,000,000]. Assuming the fee is subject to a high-water mark, no incentive compensation would be paid after year 2 or 3. After year 3, the Tax-Exempt Investor's units have a value of $1,300,000, with a net investment gain of $300,000. This equates to the Tax-Exempt Investor deriving 60% of the gain and the fund manager earning 40% of the gain. Based on this arrangement, when viewed as a multi-year arrangement, the fund manager has gained far more than the "20% incentive fee" payable to the fund manager. Because of Section 457A, there has been misalignment of the interests of the Tax-Exempt Investor and the fund manager and, unless the investor specifically negotiated a clawback of the compensation, is arguably in a worse position than under a multi-year arrangement prior to Section 457A.

Stock Options and Stock-Settled Stock Appreciation Rights Under Section 457A

Section 457A generally covers the same "nonqualified deferred compensation plans" as those covered under Section 409A.[7] Under Section 409A, a "nonqualified deferred compensation plan" is a plan that provides for (or may provide for) the payment of compensation to a service provider in a year later than the year in which the service provider has a legally binding right to such compensation.[8] Section 409A generally excludes from the definition of "nonqualified deferred compensation plan," stock options and stock appreciation rights ("***SARs***") that are granted with an exercise price that is no less than the fair

[7] Code § 457A(d)(3).
[8] Code § 409A(d), Treas. Reg. § 1.409A-1(b)(1).

market value of the underlying service recipient stock issued at the time of grant.[9] Unlike Section 409A, however, Section 457A specifically 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."[10] This statutory language, when read broadly, appears to cover SARs as a form of deferred compensation under Section 457A.

Following the enactment of Section 457A, the IRS issued guidance under IRS Notice 2009-8, 2009-4 I.R.B. 347 ("***Notice 2009-8***"), which attempted to clarify that stock options and "stock-settled" SARs (effectively, net or cashless exercise stock options) that otherwise meet the exemption from nonqualified deferred compensation under Section 409A should not be treated as deferred compensation under Section 457A.[11] The IRS specifically made the distinction that SARs that are settled in stock, as opposed to cash, are excluded from coverage under Section 457A.[12] Further, the IRS attempted to address the application of the foregoing rules in the context of non-corporate service recipients, stating that, "for purposes of applying the exception from coverage under § 1.409A–1(b)(5)(i)(A) to an equity interest in a non-corporate entity (meaning a right to purchase actual equity in such entity, and not a mere right to an amount equal to the appreciation in such equity), the rules of § 1.409A–1(b)(5)(i)(A) are applied by analogy."[13] Accordingly, for non-corporate service recipients, options and equity-settled appreciation rights of the non-corporate would similarly be excluded from Section 457A.

Notwithstanding the guidance issued by the IRS, many hedge fund managers were wary that the "stock-settled" SAR exception would not apply in the context of deferrals paid by offshore investment funds. With potentially significant deferrals at stake, and without clear authority and guidance the IRS, many fund managers were simply unwilling to embrace the exemption as a valid means of fee deferral. In response to Section 457A, fund managers embraced other arrangements to address Section 457A concerns. Notably, many incentive fee arrangements were structured as performance allocations payable on partnership interests or as profits interests, which generally are not subject to Section 457A.[14]

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[9] Treas. Reg. § 1.409A-1(b)(5).

[10] Code § 457A(d)(3).

[11] Notice 2009-8, Q&A 2(b).

[12] *Id.* ("the exception from coverage under § 1.409A–1(b)(5)(i)(B) may be applied so that a stock appreciation right which by its terms at all times must be settled in service recipient stock, and is settled in service recipient stock (and otherwise meets the requirements of that section), will be excluded from coverage under § 457A").

[13] Notice 2009-8, Q&A 2(b).

[14] Notice 2009-8, Q&A 2(a) ("[w]ith respect to an arrangement between a partner and a partnership, taxpayers may rely upon the applicable guidance under § 409A, which as of January 9, 2008, included Notice 2005–1, Q&A–7, 2005–1 C.B. 274, § II.E of the preamble to the proposed § 409A regulations published on October 4, 2005 (REG–158080–04, 2005–2 C.B. 786 [70 Fed. Reg. 57930]) and § III.G of the preamble to the final § 409A regulations published on April 17, 2007 (T.D. 9321, 2007–1 C.B. 1123 [72 Fed. Reg. 19234])."). IRS Notice 2005–1, Q&A–7 provides that, "until additional guidance is issued, for purposes of § 409A taxpayers may treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock (see Q&A 4). Specifically, until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated under applicable guidance as not resulting in inclusion of income by the service provider at the time of issuance, as also not resulting in the deferral of compensation. Similarly, until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a capital interest in connection with the performance of services in the same manner as an issuance of stock. The § 409A rules governing other stock-based compensation may be applied by analogy to grants of equity-based compensation where the compensation is determined by reference to partnership equity. In addition, until further guidance is issued, taxpayers may treat arrangements providing for payments subject to § 736 as not being subject to § 409A, except that an arrangement providing for payments which qualify as payments to a partner under § 1402(a)(10) are subject to § 409A." For investment funds with "side-pocket" arrangements, the use of partnership interests with performance allocations became the norm to address Section 457A concern for such arrangements.

IRS Ruling – Revenue Ruling 2014-18

In response to requests for additional clarity on the matter, the IRS issued Revenue Ruling 2014-18, I.R.B. 2014-26 (June 23, 2014) (the "***Ruling***"). The Ruling amplified the guidance in Notice 2009-8 in the form of a formal ruling by the IRS, and confirmed that stock options and stock-settled SARs, when properly structured, are exempt from Section 457A. As drafted, the Ruling indicates that the exception would apply to many common hedge fund structures, as the parties described in the Ruling closely resemble common offshore investment fund and fund manager relationships. The service recipient in the Ruling was an entity that was organized and taxed as a foreign corporation and the service provider was a limited liability company that was taxed as a partnership, with allocations to U.S. taxpayers. The Ruling provides that the compensation arrangement between the service provider and the service recipient is a stock option or stock-settled SAR that otherwise meets the requirements to be exempt from Section 409A.[15] Both the stock option and the stock-settled SAR must be settled in service recipient stock.[16] The service provider (i.e., the fund manager) has the same redemption rights with respect to any shares received upon exercise as any other shareholder of the service recipient (i.e., the investors). Because the stock option and stock-settled SAR are not deferred compensation arrangements under Section 457A, any inherent gains are realized and included in income by the fund manager only upon the exercise of the stock option / stock-settled SAR.

In the context of an investment fund, which may be structured as a corporation or a partnership, the Ruling illustrates the ability to provide equity-settled appreciation rights (referred to herein as, "***ESARs***"), to the fund manager. Thus, the Ruling opens the door to potentially structuring a compensation arrangement that could realign the interests of the fund manager and the investors, and for fund managers that were reluctant to adopt such arrangements, the Ruling may provide some comfort that the arrangement will be respected by the IRS. On a basic level, continuing with the example above, an ESAR arrangement can be illustrated as follows:

> Tax-Exempt Investor acquires 1,000 units of Offshore Fund at a net asset value (NAV) price of $1,000 per unit. Offshore Fund issues ESARs to the fund manager purchase 200 units at an exercise price of $1,000 per unit (i.e., at NAV at issuance). The vesting of the ESARs and the timing of the exercise may be negotiated by the fund manager and Tax-Exempt Investor (e.g., after a fixed number of years or upon the occurrence of certain events such as the exiting of the investor). For purposes of this example, the ESAR is exercisable on the third anniversary of the date of grant. After year 1, the NAV per unit rises up to $2,000 per unit, but then after year 2, it drops to $1,800 per unit, and then after year 3, drops further to $1,500 per unit. If the ESARs are fully exercised after year 3 and the fund manager's units are redeemed thereafter in accordance with the terms of

[15] Under Section 409A, stock options and stock-settled SARs generally meet the requirements for exemption from Section 409A if the awards are for a fixed number of shares of the service recipient, the exercise price is not less than the fair market value of the shares on the date of grant, and there no other features for the deferral of compensation. *See generally* Treas. Reg. § 1.409A-1(b)(5).

[16] Ruling ("Although stock appreciation rights are generally subject to section 457A, a stock appreciation right that at all times by its terms must be settled, and is settled, in service recipient stock is functionally identical in all material respects to a nonstatutory stock option to purchase service recipient stock with a net exercise feature, and the stock transfer under such an arrangement, like the stock transfer pursuant to the exercise of a nonstatutory stock option, is taxable under section 83. Accordingly, a nonstatutory stock option exempt from section 409A is exempt from section 457A. In addition, a stock appreciation right exempt from section 409A that at all times by its terms must be settled, and is settled, in service recipient stock is exempt from section 457A. A stock appreciation right that may be or is settled other than in service recipient stock is not exempt from section 457A, regardless of whether the stock appreciation right is a nonqualified deferred compensation plan for purposes of section 409A.")

Offshore Fund's governing documents, the value of the exercise to the fund manager is $100,000 [($1,500-$1,000) x 200 = $100,000]. The remaining Tax-Exempt Investor's units have a value of $1,400,000, with a net investment gain of $400,000. This equates to the Tax-Exempt Investor deriving 80% of the gain and the fund manager earning 20% of the gain. For compensation based on multi-year performance, this provides a true "20% incentive fee" to the fund manager at the end of the performance period. The ESARs in this example provide an intrinsic "clawback" of the incentive compensation in the poorer performing years. As compared to the annual fee example, the Tax-Exempt Investor is a far better position using ESARs than if the compensation been arranged as an annual fee, and arguably the appropriate result for both the fund manager and the Tax-Exempt Investor has been achieved.

ESARs can be drafted to fit a wide variety of arrangements, with flexibility to negotiate when they will vest and when they may be exercised, to fit the business arrangement between the investor and the fund manager. While the possible compensation arrangements are promising, there still remain a number of issues that are uncertain following the Ruling, and ESARs may not be appropriate in all situations. As noted in the Ruling, the ESAR arrangement only works if the service provider is granted ESARs for "service recipient stock."[17] For more complex investment fund structures and the provision of services across multiple funds, it may be more difficult to determine if the EARs have been granted for service recipient stock. And, as with stock options and SARs under Section 409A, subsequent modifications to the ESARs following their date of grant, must be limited to avoid extensions or other changes that could result in the impermissible deferral of income. Careful analysis would be necessary to confirm that the arrangements (or changes to the arrangements) satisfy the exemption requirements under Section 409A (and in turn, the requirements under Section 457A). There are also questions as to how soon following the exercise of an ESAR, the equity units may be redeemed. While the Ruling stated that the service provider has the same redemption rights with respect to any shares received upon exercise as any other shareholder of the service recipient, it is not entirely clear if an arrangement would be respected as "stock-settled" in all situations, including those in which a redemption may occur immediately following the settlement. Further, there are also some other cross-border international issues that may need to be addressed as well, including, issues arising under the "passive foreign investment company" (PFIC) rules.

Conclusion

Section 457A significantly altered the landscape for offshore fee deferrals and in the process, created a misalignment of interests between certain investors and the fund managers. The Ruling provides some clarity on the use of ESAR arrangements and may allow fund managers who were previously unwilling to consider the use of such arrangements to reconsider their use as a possible solution that avoids the restrictions of Section 457A. Although ESARs may not be appropriate for all investment funds for business reasons or tax reasons, there may be certain investments funds and investors in which this solution may be appropriate. For many tax-exempt and other institutional investors, the ESAR may be an attractive compensation arrangement that provides a means of deferring compensation for the fund manager, as well as a realignment of the interests of the investors and the fund managers in a post-Section 457A environment.

[17] *See supra* fn. 14. This may present some challenges, for example in a master-feeder structure, if the ESARs are granted at the feeder level as opposed to the master fund level. If the feeder is a pass-through entity (e.g., a "plan asset" feeder structured as a directed investment into the master fund to reduce concerns under the Employee Retirement Income Act of 1974, as amended), it is not clear if the feeder would be respected as the service recipient for purposes granting EARs.