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New Possibilities to Defer Offshore Compensation

Managers of offshore hedge funds may want to take a fresh look at deferring performance-based compensation based on a just-released IRS revenue ruling (Rev. Rul. 2014-18), which expands their ability to do so.

Under Section 457A of the Internal Revenue Code, added in 2008, the deferral provisions in some compensation arrangements are ignored for U.S. tax purposes if the service recipient is subject to Section 457A (generally, a tax-indifferent party). The result is that the service provider (e.g., a hedge fund manager) is taxed before the deferred payment is actually received, sometimes with a 20% penalty tax added. A purpose of Section 457A was in fact to curb revenue losses resulting from deferrals of fee compensation by managers of offshore hedge funds and certain other persons. As a result of the enactment of Section 457A, offshore deferral arrangements have been regarded as officially dead, other than certain grandfathered positions and arrangements that include service-based risk of forfeiture.

Under the facts of Revenue Ruling 2014-18, the service provider was granted an option to acquire stock of the service recipient (an entity subject to Section 457A) and a stock appreciation right ("SAR") over the same stock. The strike price of the option was the grant-date fair market value of the shares, as was the appreciation base of the SAR. By their terms, both the option and the SAR settled in shares of the service recipient's stock. On settlement, the service provider would be subject to tax at ordinary income rates, which it would have to pay from separate funds. Once it owned these shares, the service provider would have the same redemption rights with respect to those shares as other holders of common shares.

The IRS ruled that both the option and the SAR on these facts are exempt from Section 457A. The IRS first noted that Section 457A applies its non-deferral rule to "compensation based on the appreciation in value of a specified number of equity units of the service recipient." Based on the legislative history of Section 457A, however, the IRS concluded that Congress did not intend Section 457A to apply to stock options that settle in stock. The IRS went on to conclude that SARs settled in stock are functionally identical to options settled in stock. Although the ruling addresses only "stock" arrangements, it appears that the same principles should apply to options and SARs granted with respect to partnership or LLC interests, although implementing such a plan in that context may raise other income tax issues.

A possible arrangement that appears to be permissible under this ruling is an agreement whereby a hedge fund manager would be entitled to a pre-determined portion (e.g., 20%) of the net capital appreciation attributable to a series of hedge fund shares on a specific date in the future (e.g., the second or third year anniversary of the issuance of such shares). A similar result could be obtained through the use of options.

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Unlike the typical pre-Section 457A deferral arrangements, the entitlement to the compensation deferred through the option or the SAR would crystalize only on the settlement date (as opposed to, for instance, every year-end) and would be settled in the same shares of the hedge fund (and not in cash).

A manager considering a deferral plan using options should be aware that for reasons not discussed in the ruling, under the so-called PFIC rules, the taxation of any gain on the ultimate disposition of the shares received may be more favorable if an SAR plan were used.

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