

AN ALERT FROM THE BDO EXECUTIVE AND HR SERVICES PRACTICE

BDO KNOWS:

COMPENSATION & BENEFITS



► SUBJECT

LIMITED DEFERRED COMPENSATION OPPORTUNITIES FOR HEDGE FUND MANAGERS UNDER SECTION 457A

The Service recently issued Rev. Rul. 2014-18, which clarifies that properly designed stock options and stock-settled stock appreciation rights (“SARs”) are forms of deferred compensation that may be granted to service providers (including hedge fund managers) of certain hedge funds and entities that are based in foreign tax havens. Such awards are exempt from section 457A, which generally precludes deferred compensation arrangements between these service providers and service recipients. This ruling is consistent with the Service’s earlier statement in Q&A-2(b) of Notice 2009-8 (the interim guidance for section 457A).

► BACKGROUND

Section 457A was enacted in 2008 to promote parity between the tax treatment of nonqualified deferred compensation plans sponsored by United States companies and those sponsored by offshore companies that are based in tax haven jurisdictions (or more precisely, under section 457A’s terminology, “nonqualified entities”).

The Service provides a complex body of rules for determining whether a sponsor of a nonqualified deferred compensation plan is a “nonqualified entity” for a given period. However, the overall concept is rather straight forward: a nonqualified entity is a service recipient with no (or a materially lower) tax liability for substantially all (*i.e.*, at least 80 percent) of its gross income for the taxable year. This rule sweeps all partnerships into the definition, unless substantially all of the partnership income is allocated to persons subject to a comprehensive income tax system. So in short, a nonqualified entity is a tax-indifferent entity that suffers no economic loss inasmuch as the timing of the deduction for the compensation is not relevant when the company does not have

CONTACT:

ANDREW GIBSON
404-979-7106
agibson@bdo.com

TONY DASILVA
617-239-7036
tdasilva@bdo.com

PETER KLINGER
415-490-3214
pklinger@bdo.com

CARL TOPPIN
212-885-8331
ctoppin@bdo.com

JOAN VINES
301-634-0250
jvines@bdo.com

a tax liability. By contrast, United States companies that provide nonqualified deferred compensation to their workers are unable to receive a tax deduction for the deferred compensation until the amount is paid to the service provider. The Code, prior to the enactment of section 457A, provided a significant tax benefit to service providers, without any corresponding tax disadvantage to their offshore service recipients.

In light of these policies, section 457A generally imposes federal income tax on compensation deferred under a nonqualified deferred compensation plan sponsored by a nonqualified entity when the service provider's right to the compensation becomes vested. If, however, the amount of deferred compensation is not determinable at the time of vesting, taxes are imposed when the amount becomes determinable and an additional 20-percent tax and interest for late income inclusion will be imposed.

► COVERED AND EXCLUDED PLANS

Section 457A generally precludes the deferral of compensation paid in cash beyond the date of vesting. As such, a stock appreciation right that provides a right to receive cash equal to the appreciation in the service recipient's equity is a deferred compensation arrangement covered by section 457A.

Reiterating its earlier guidance, the Service held in Rev. Rul. 2004-18 that nonstatutory stock options are exempt from section 457A, provided they are issued with an exercise price not less than fair market value at the date of grant and contain no other deferral feature. The ruling further states that stock appreciation rights that must be settled in the service recipient's stock, and not an amount equal to the appreciation in such equity, are excluded from coverage under section 457A. These SARs are functionally identical to a nonstatutory stock option to purchase service recipient stock with a net exercise feature. While the ruling specifically applies to the use of nonqualified stock options and SARs, the rationale may also apply to equity interests in a partnership or limited liability company classified as a partnership for federal tax purposes.

► OPPORTUNITIES

This recent ruling confirms that long-term incentive compensation may be delivered by a nonqualified entity (e.g., an offshore hedge fund in a tax haven jurisdiction) to its service provider (e.g., a hedge fund manager) in the form of stock options or stock-settled SARs, granted at a price equal to the fair market value of the fund's equity on the date of grant; and the hedge fund managers will be able to defer compensation income attributable to the stock option/SAR until exercise. This incentive arrangement may provide a tax-efficient mechanism for delivering performance-based compensation to hedge fund managers and other service providers of nonqualified entities.

The Tax Practice at BDO is among the largest tax advisory practices in the United States. With 49 offices and more than 400 independent alliance firm locations in the United States, BDO has the bench strength and coverage to serve you.

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through 49 offices and over 400 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multinational clients through a global network of 1,264 offices in 144 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information, please visit www.bdo.com.

To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

Material discussed in this tax alert is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.