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SUBJECT

HEDGE FUND MANAGERS MAY SEE CHANGE IN PERFORMANCE-BASED COMPENSATION UNDER 457A

If you are a service provider, such as a hedge fund manager, you probably felt the effects of 457A. In 2008, the IRS enacted section 475A to promote uniformity in tax treatments between U.S. companies and offshore companies based in tax haven jurisdictions. Specifically, the legislation was developed to address the treatment of nonqualified deferred compensation plans. The ruling effectively precludes U.S. hedge fund managers from deferring taxes on compensation paid by offshore funds located in tax havens.

To understand this ruling and its implications, it is important to first understand how the IRS determines which companies are based in tax haven jurisdictions or, as 457A classifies them, are considered

"nonqualified entities." A nonqualified entity is, in general, a service recipient with no tax liability for at least 80 percent of its gross income for the taxable year. Prior to section 457A there was a huge discrepancy between U.S. companies and nonqualified entities: U.S. companies were unable to receive tax deductions for deferred compensation until the amount was paid to a service provider (thus benefiting the provider), while offshore service recipients had no such tax disadvantages.

Following the passage of 457A, confusion abounded over what, if any, awards were exempt from 457A. In response this past June, the IRS issued Rev. Rul. 2014-18. The ruling clarifies that properly designed nonqualified stock options and stock-settled stock appreciation rights (SARs) are forms of deferred compensation that may be granted to service providers of hedge funds and like entities based in foreign tax havens. Put simply, in certain circumstances incentive fees payable can be deferred.

This clarification could effectively change the way that hedge funds structure their incentive plans and how managers receive compensation, providing a tax-efficient way for delivering performance-based pay. Per the ruling, long-term incentive compensation may be delivered by a nonqualified entity in the form of stock options or SARs to its service provider. This

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method is contingent, however, on the stock options or SARs being granted at a price equal to the fair market value of the fund's equity on the day of the grant and these grants may not provide any other deferral right beyond the timing of the exercise. Additionally, stock appreciation rights must be settled in service recipient stock only and not an amount equal to the appreciation. While Rev. Rule 2014-18 applies specifically to stock options and stock appreciation rights, the rationale may also apply to equity interests in partnerships or limited liability companies classified as partnerships.

Will compensation structures change in response to the ruling? Only time will tell.