

Anchin Alert

Anchin, Block & Anchin LLP
Accountants and Advisors



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Revenue Ruling 2014-18 – New Possibilities to Defer Offshore Compensation of Hedge Fund Managers and Employees

On June 10, 2014, the Internal Revenue Service issued a ruling holding that non-statutory (or nonqualified) stock options (“NSO”) and stock-settled stock appreciation rights (“SARs”) are not subject to Internal Revenue Code Section 457A (“Section 457A”). Generally, Section 457A prohibits deferred compensation for service providers to certain tax-indifferent entities, or nonqualified entities, including entities based in foreign tax havens or pass-through entities that are more than 20% owned by tax-exempt entities. Prior to the enactment of Section 457A, fund managers often deferred their management fees and incentive fees with respect to their offshore funds. To our knowledge, this ruling addresses the potential deferral of incentive fees (and not management fees).

In Revenue Ruling 2014-18 (the “Ruling”), a foreign corporation (an offshore fund or a nonqualified entity under Section 457A) received services from a U.S. partnership (the onshore hedge fund manager). In exchange for these services, the foreign corporation granted a NSO and a SAR, each with respect to a fixed number of its common shares, to the U.S. partnership as incentive compensation. Each stock right had an exercise price per share not less than the fair market value of the requisite associated common share of the foreign corporation on the date of grant and did not include any feature constituting the deferral of compensation under the section 409A Treasury Regulations. The terms of the SAR at all times provided that the stock right must be settled in stock of the foreign corporation. The U.S. partnership also had the same redemption rights with respect to the common shares upon the exercise of the stock rights as other shareholders had with respect to their common shares of the foreign corporation.

On these facts, the Ruling found that neither the NSO nor the SAR constituted deferred compensation under Section 457A. As a result, taxation would occur only upon exercise and would be based on the excess of the fair market value of the shares at exercise over the applicable exercise price. Therefore, the NSO or SAR would not need to meet the annual payment rule of Section 457A but could be exercisable after a multi-year performance period.

This Ruling could afford fund managers an additional compensation option with respect to their offshore fund via the strategic use of NSOs or SARs. A NSO or SAR might not be the best compensation arrangement in every situation, but in many cases they may prove a tax efficient way to compensate fund managers for their services in a manner that may better align the compensation realized with the time horizon of those services. The timing on implementing such a plan should also be carefully thought out and discussed with your tax advisors.

New rulings can offer unique and innovative planning opportunities. However, be wary of quick answers and simple advice. The Ruling did not address other potential tax issues that may arise when using options: (1) the applicability of the passive foreign investment company (“PFIC”) tax rules under Internal Revenue Code Sections 1291-1298; (2) the fact that all deferred fees under a NSO or SAR plan will be ordinary income when they are received (under Internal Revenue Code Section 83) irrespective of the underlying character of the gains in the relevant offshore fund); and (3) whether any other deferral arrangements are already in place which could now be in violation of Internal Revenue Code Section 409A (or Section 457A), to name a few. Before taking action, taxpayers should completely analyze their specific facts and circumstances and should consult with their tax advisor(s). We will continue to monitor for any

additional guidance and developments and will alert you as information becomes available. In the meantime, if you have any questions, please contact your engagement partner or any partner in **Anchin's Financial Services Group** at your earliest convenience. We stand ready, as **Your Expert Partner**, to help you plan effectively and to assist you in navigating through these rules.

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