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New IRS Revenue Ruling 2014-18 and the Use of Hedge Fund Stock Options

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Synopsis

The Internal Revenue Service has issued Revenue Ruling 2014-18[1] (the "Ruling") to clarify that stock options and stock-settled stock appreciation rights ("SARs"), properly designed, can be used as a form of compensation to managers of hedge funds and other "nonqualified entities" without being considered nonqualified deferred compensation under Internal Revenue Code Section 457A ("Section 457A"). The Ruling is consistent with the position our Firm has taken since 2009 when Section 457A first became effective.[2]

Background

Section 457A generally prohibits deferred compensation for service providers to certain tax-indifferent entities, referred to as "nonqualified entities," including companies based in foreign tax havens or pass-through entities that are more than 20% owned by tax-exempt entities.

As a result of Section 457A, many hedge fund managers have been receiving incentive fees from the funds they manage in the form of annually determined compensation. A number of institutional investors have noted that such annually determined incentives could result in misaligned compensation opportunities, with high payouts in good years and little likelihood of clawing back those high payouts in bad years.[3] Consider the following example, using a hypothetical $100 million fund that pays a 20% annual incentive fee to its manager:

> Example 1: Year 1 is a good year, with a 50% gain. The manager receives an incentive allocation of $10 million (i.e., 20% of the $50 million gain for the year), which it leaves invested in the fund. The investors hold the remaining $140 million interest in the fund.
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> Year 2 is a bad year, with a $33^1/_3$% loss. The fund has returned to its $100 million original value. The investors' $140 million interest in the fund

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[1] I.R.B. 2014-26 (June 23, 2014).

[2] See, e.g., "Compensating Hedge Fund Managers with Stock Options: A New Path to Alignment of Interests with Investors," by James E. Earle, Benefits Law Journal, Vol. 23, No. 3 (Autumn 2010).

[3] See, e.g., Press Release, "CalPERS Moves to Restructure Hedge Fund Relationships—Seeks Better Model for Alignment, Control, Fees and Transparency," March 27, 2009:

> The present model provides the possibility of a hedge fund manager realizing a 20 percent performance fee at the end of a bonanza year. If the fund suffers a significant decline the next year, the manager could still have a large net gain at the end of the two years, but the investor may break even or even lose money. . .
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> Performance fees should be based on long-term performance, and mechanisms such as delayed realizations and clawbacks can better align long-term interests of managers and investors.

> decreases in value to $93.33 million—a $6.67 million loss over the two years. Although the manager's $10 million interest from Year 1 decreases in value to $6.67 million, the manager still has realized positive incentive compensation over the two years for delivering to the investors a net loss!

An elegant solution to this compensation alignment problem is to deliver the manager's incentive fee in the form of a stock option or stock-settled SAR, with a grant price equal to the fair market value of the fund shares on the date of grant. The manager does not realize value from the stock option/SAR until it is exercised. The stock option/SAR can prohibit exercise until after a certain specified period of time, potentially covering multiple years, aligned to the investors' time horizon in the fund. In this manner, the time horizon for the incentive compensation may be better aligned to the time period for which the services are being provided. The stock option/SAR also provides a self-executing, well-aligned clawback for down years prior to exercise. Consider the example above if a stock option had been used instead of an annually-determined incentive fee:

> Example 2: In our $100 million fund, manager is granted a stock option on $20 million worth of stock in the fund with an aggregate strike price of $20 million.
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> After Year 1 (a good year with a 50% gain), the shares underlying the manager's stock option are now worth $30 million. If the terms of the stock option award so permit, the manager could exercise the option and realize a $10 million gain (i.e., purchase $30 million in stock for a $20 million strike price).
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> But suppose the manager does not (or cannot) exercise the option at the end of Year 1, and in Year 2 there is a $33^1/_3$% loss. The shares are now worth exactly the same as at the beginning of Year 1. The investors' interest is worth the original $100 million initial investment, and the stock options are worth $0. Compared to Example 1 above, from the investors' perspective, this is arguably a more appropriate overall compensation result.

Q&A-2(b) of IRS Notice 2009-8[4] stated that stock options and stock-settled SARs that otherwise meet the exemption from the deferred compensation rules under Internal Revenue Code Section 409A ("Section 409A") should not be treated as deferred compensation under Section 457A. Nonetheless, some advisors to hedge fund managers counseled that Notice 2009-8 might not apply in the context of compensation arrangements between hedge funds and their managers. The Ruling should erase any such concerns.

The Ruling

The Ruling assumes that a Service Recipient, organized as a foreign corporation that is a nonqualified entity under Section 457A, has a service relationship with an unrelated Service Provider organized as a limited liability company, taxed as a partnership, with income allocations to U.S. taxpayers. The Ruling further assumes that the Service Recipient grants to the Service Provider a nonqualified stock option and a stock-settled SAR. Both the stock option and the stock-settled SAR otherwise meet the requirements for exemption from Section 409A. In particular, the awards are for a fixed number of common shares of the

[4] I.R.B. 2009-4 (Jan. 26, 2009).

Service Recipient, include an exercise price not less than the fair market value of the common shares on the date of grant, and include no other feature for the deferral of compensation under Section 409A. The stock-settled SAR requires settlement upon exercise by delivery of shares. The Service Provider has the same redemption rights with respect to any shares received upon exercise as any other shareholder in the Service Recipient.

On these facts, the Ruling finds that neither the stock option nor the stock-settled SAR constitutes deferred compensation that is subject to Section 457A. As a result, taxation should occur only upon exercise based on the "spread" (i.e., the excess of the fair market value of the shares at exercise over the applicable exercise price) realized upon exercise.

One of the concerns about the potential applicability of Section 457A to stock options or stock-settled SARs derives from the statutory language itself. Section 457A generally defines "deferred compensation" by reference to the Section 409A definition. Section 457A goes further, however: the statutory language also provides that "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" is a form of deferred compensation under Section 457A.[5]

By including "compensation based on the appreciation in value of a specified number of equity units," Section 457A's statutory definition of "deferred compensation" would initially appear to potentially include stock options or stock-settled SARs. Consistent with the legislative history for Section 457A,[6] however, IRS Notice 2009-8 expressly states that stock options that otherwise meet the requirements of the Section 409A regulations do <u>not</u> constitute deferred compensation under Section 457A.[7] In other words, a stock option that satisfies Section 409A automatically also satisfies Section 457A under Notice 2009-8. The Ruling amplifies this position, and the factual context of the Ruling indicates that the position could apply in the typical hedge fund manager context.

The Ruling also further explains that a stock-settled SAR will be treated the same as a stock option. The Ruling indicates that a stock-settled SAR is "functionally identical" to a nonqualified stock option and, therefore, will be treated the same for purposes of Section 457A.[8]

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[5] Section 457A(d)(3)(A).

[6] See, e.g., Blue Book 2009: Joint Committee on Taxation's General Explanation of Tax Legislation Enacted in the 110th Congress, p. 529.

[7] Paragraph A-2(b) of Notice 2009-8 states, in relevant part, as follows:

> As provided in § 457A(d)(3)(A), the term *nonqualified deferred compensation plan* also 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. Accordingly, except as otherwise provided in this paragraph A-2(b), § 1.409A-1(b)(5)(i)(B) (exception for certain stock appreciation rights) does not apply for purposes of determining whether an arrangement provides for deferred compensation for purposes of § 457A. However, the exceptions from coverage under § 1.409A-1(b)(5)(i)(A) (exception for nonstatutory stock options on service recipient stock issued with an exercise price not less than fair market value at the date of grant and with no other deferral feature) and § 1.409A-1(b)(5)(i)(C) (exception for statutory stock options) apply.

[8] Under Notice 2009-8 and the Ruling, a cash-settled SAR will be treated as "compensation based on the appreciation in value of a specified number of equity units," and, therefore, will be considered deferred compensation that is subject to Section 457A. While logically there should be no tax distinction between cash-settled and stock-settled SARs, the IRS clearly felt constrained by Section 457A's statutory language and legislative history.

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Conclusion: What's Next

The Ruling could open the door for hedge funds and other types of nonqualified entities under Section 457A to devise alternative compensation arrangements with fund managers and other service providers. A stock option or stock-settled SAR might not be the best compensation arrangement in every situation, but in many cases, a stock option or stock-settled SAR may provide a tax efficient mechanism to compensate managers for their services in a manner that is designed to better align the compensation realized with the time horizon of those services.

Before adopting a stock option or stock-settled SAR program, however, care should be taken in the design of the program. The awards must meet a number of technical requirements under Section 409A. The parties should also consider the potential applicability of the "passive foreign investment company" tax regime found at Internal Revenue Code Sections 1291-1298. Other practical considerations may be important, such as how to document and administer the awards, how to administer redemptions, etc.

If you have any questions, please do not hesitate to contact the K&L Gates attorney with whom you regularly work.

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