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Deferred Compensation

Ted Dougherty, Lisa Sergi, and Elizabeth Drigotas of Deloitte Tax write that with a tax overhaul's potential elimination of carried interest, private equity and hedge fund managers should be considering alternative deferred compensation plans and option or fund appreciation plans.

Investment Manager Fee Deferrals: The Next Era

BY TED DOUGHERTY, LISA SERGI, AND ELIZABETH DRIGOTAS

With the very real possibility that carried interest may be eliminated with tax reform, it is time to turn our attention to potential tax planning considerations for private equity and hedge fund managers. As discussed below, appropriately structured deferred compensation plans and option or fund appreciation plans may offer potential planning for managers after the loss of carried interest.

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Indeed, in addition to offering managers a post-carried-interest approach, the tax deferral considerations discussed below would provide a current benefit to hedge fund managers whose funds predominately generate ordinary income or short-term capital gains and to those managers who can only earn fees from a separately managed account.

Background

The ability to take a profit allocation in the form of a carried interest has been around for many years, and aside from various legislative proposals to repeal it introduced almost yearly since 2007, this technique hasn't been challenged by the Internal Revenue Service or in the courts.

In a typical carried interest plan, at the close of each tax year, realized and unrealized gains and losses are allocated for book purposes between the general partner and the limited partners based upon previously agreed formulas. The general partner (or related fund manager) benefits from the allocation of unrealized gains, and any tax preferences in the form of reduced rates that may apply to realized long-term capital gains and qualified dividend income.

In a typical hedge fund, once an allocation of profit is made to the general partner, subsequent losses don't cause the general partner to disgorge the previous allocation. This issue has been a cause for concern on the part of investors since the financial crisis. This is in stark contrast to the typical provisions in a private equity fund that provide for a clawback if the fund later has losses. These provisions require the general partner

to contribute capital in later years to the extent it withdrew amounts related to its carried interest in excess of its agreed upon net income sharing ratio with limited partners as a result of subsequent losses. In the years when there is profit to allocate to the general partner, most agreements provide that the general partner is entitled to a tax distribution.

The carried interest allocation model has been the standard in the hedge fund space since 2009, for reasons explained below, and in the private equity space since the industry launched.

Prior to 2009, many hedge fund managers utilized a two-tiered incentive fee structure. In the domestic fund, they would take the carried interest and enjoy the tax attributes that passed through, as discussed above. In an offshore fund, they had the ability to make an election, assuming the manager was on a cash basis method of accounting, to defer receipt of the incentive fee (as well as the management fee) for a term specified by the manager.

In this scenario the manager could lock in its fee annually, and during the period of deferral, the entire fee would compound at the same rate of return as the offshore fund. Since most investors in an offshore fund are non-U.S. persons or U.S. tax-exempt institutions, the fact that the matching principle would defer the deduction of such fees to such investors was essentially moot.

Congress became concerned with deferred compensation generally in the early 2000s, and passed legislation in the form of Internal Revenue Code Section 409A to provide parameters that must be met in order for deferred compensation programs to work. Those rules, while more restrictive than prior law, were relatively easy to comply with, and so hedge fund managers quickly found ways to work within them.

However, Congress then became concerned that deferrals by fund managers provided an unfair advantage relative to other taxpayers, given the indifference of the offshore investors with respect to timing of any related deduction. Although there was no way to measure how much untaxed income existed in these offshore fund vehicles, estimates between $100 billion and $500 billion were routinely mentioned.

Finally, in 2008 Congress passed Internal Revenue Code Section 457A, which effectively shut down offshore hedge fund fee deferrals starting with the 2009 tax year, unless certain parameters were met. At the time, the hurdles posed by these parameters were thought to be steep; particularly in light of hedge fund managers' ability to utilize the carried interest structure, most if not all converted their fee structures to a carried interest model. Congress did provide a 10-year grandfathering period for amounts that had been deferred offshore prior to 2009 (with such period ending in 2017).

Under the assumption that some form of carried interest legislation may ultimately pass, it is now worth exploring nonqualified deferred compensation under Section 457A, and other alternative structures for tax deferral.

Section 457A

Section 457A provides that any compensation that is deferred under a nonqualified deferred compensation plan of a ''nonqualified entity'' shall be includable in gross income when there is no ''substantial risk of forfeiture'' of the rights to such compensation. There are two important terms used in this provision that determine how the rules work.

A nonqualified entity means:

- any foreign corporation unless substantially all of its income is effectively connected with the conduct of a trade or business in the U.S., or is subject to comprehensive foreign income tax; and
- any partnership unless substantially all of its income is allocated to persons other than foreign persons with respect to whom such income isn't subject to a comprehensive foreign income tax, and organizations which are exempt from U.S. taxation.

Essentially this rule provides that if the service recipient is a tax-indifferent party, the service recipient is a nonqualified entity.

Compensation amounts are treated as being subject to a substantial risk of forfeiture (SROF) when the rights of a person to compensation are conditioned upon the future performance of substantial services by such person. (The language of the statute is that the right to the compensation is conditioned on the services of ''any individual,'' but Notice 2009-8 adopts a more traditional condition for a substantial risk of forfeiture, providing that the person's rights to the compensation are conditioned on substantial services by such person.)

If a nonqualified deferred compensation plan fails one part of the two-part test under Section 457A (services provided to a nonqualified entity, or there is no SROF), then in addition to being liable for the tax and any interest on underpayment of the tax, an additional 20 percent penalty tax will be imposed on the deferred amount when paid.

At the time Section 457A was enacted, hedge fund managers moved away from these kinds of nonqualified deferred compensation plans because they were able to utilize the carried interest rules, which provided managers with tax-preferred rates if the fund produced long-term capital gains or qualified dividend income. There was little appetite to determine the confines of the SROF rule.

Should a hedge fund or private equity manager consider establishing a plan that provides for a risk of forfeiture in order to achieve tax deferral? It seems likely that when carried interest is no longer available, many managers will be interested in exploring this issue. As noted above, managers that receive only short-term capital gain or interest income may be interested in exploring such deferral currently.

What would the IRS deem to be a SROF? The statutory language is actually quite clear: There will be a SROF if the person's rights to compensation are conditioned upon the performance of substantial services in the future (Internal Revenue Code Section 457A(d)(1)). It would appear the provisions contained in an investment management agreement (IMA) would need to provide terms for removal of the investment manager under certain conditions, with the result that if such removal takes place before the end of the deferral period, the deferred fee (compensation) is forfeited.

The basic notion of being able to remove an investment manager no doubt exists in virtually all existing IMAs, and such a provision would likely be enforceable assuming the fund has an independent board empowered to do so. The IMA would also need to provide that,

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should the manager resign from providing services to the offshore fund, it would forfeit any previously deferred amounts.

In the context of individual service providers, a substantial risk of forfeiture can apply only if the individual voluntarily quits, but provides for payment if the individual is terminated without cause or quits with ''good reason'' (generally limited to conditions outside the control of the individual). In the context of an entity, there is debate among advisers as to the extent to which such involuntary termination provisions can be included.

So the question then becomes, without the ability to take advantage of carried interest, will managers be willing to take the risk that the independent board might remove them in order to take advantage of the opportunity for tax deferral, or that more protective forfeiture conditions might eventually be found to be insufficient to constitute a SROF?

As a reminder, in order to establish a nonqualified deferred compensation plan that is Section 457A-compliant, the manager must be on the cash method of accounting. It is likely that most managers would seek to structure such a plan that would crystalize their fee annually, with no clawback or reduction for future losses, but include provisions providing for a substantial risk of forfeiture imposed by the continued service requirements. This may prove easier to do in a hedge fund than a private equity fund.

Options, Fund Appreciation Rights, and Stock Appreciation Rights

Another planning consideration involves the use of an options or rights plan. The option or right is granted at the time of an offshore fund's launch or admission of a new shareholder. At issuance, the strike price of the option or right is equal to the fair market value of the underlying shares (or partnership units, as applicable). If the incentive is structured to be 20 percent of future profits, then the manager is given the option or right to buy 20 percent of newly issued shares at that strike price. The option also must be issued over equity that qualifies as ''service recipient stock,'' within the meaning of Section 409A regulations. These are applied by analogy to partnership equity interests.

The investment manager and key investors in the offshore fund may agree that such options or rights may not be exercised for a specified period of time, which might coincide with the lock-up period of the investors. After the lock-up period expires, the manager would have the right to exercise the option at any time.

In order to be respected as a bona fide option or right, the form of the transaction must meet certain parameters. First, the option should only be exercised for cash equal to the strike price. In the corporate world, executives are able to do so-called cashless exercises where they don't have to pay the strike price but simply receive the fair market value of the stock less the strike price and any applicable taxes. Because there is no guidance on the use of options or rights in the fund context, most tax advisers believe that it is important that the option or right holder put up the cash to pay for the equity.

Second, after exercise the holder should continue to own the equity for some period. Different advisers have different perspectives on the length of time the stock needs to be held. These periods vary from one day to as long as six months. If the IRS was to disregard the option or rights structure, they could impose taxes and interest as well as general underpayment penalties, but these structures shouldn't be subject to the 20 percent penalty tax under 457A. A properly structured option or rights structure will generate ordinary income upon exercise, so the manager needs to be able to fund not just the strike price of the shares, but also any tax liability associated with the increase in value between the strike price and fair market value at the date of exercise.

The IRS issued a ruling in the summer of 2014—Revenue Ruling 2014-18, 2014-1 C.B. 1104—in which the agency concluded that the basic option or appreciation rights structure described above wasn't subject to Section 457A. Unfortunately, the ruling didn't provide guidance as to the appropriate holding period for the stock after exercise, although the facts in the ruling did include the statement that ''Service Provider has the same redemption rights with respect to common shares acquired upon exercise of the stock rights as other shareholders have with respect to their common shares of Service Recipient . . . .''

It is important to note that an option or rights structure provides for a different economic result than a Section 457A compliant plan, although both provide for deferral. Fundamentally, the option or rights structure provides the manager with a cumulative return during the holding period, so that if the value of the stock appreciates by $100 in the first year but declines by $100 in the second year, the manager's options or rights have no value other than the intrinsic value of the option or right itself. In a section 457A compliant plan, with annual crystallization, the manager will receive the $100 as long as the manager provides services for the requisite period even if the value of the portfolio declines in subsequent years.

Unlike a Section 457A compliant plan, the manager using an option or rights strategy doesn't have to be on the cash method of accounting. Further, unless agreed to between the manager and the offshore fund's investors, the option or rights structure doesn't require a substantial risk of forfeiture, and therefore the manager doesn't need to continue to provide the fund with services. It appears that a number of hedge fund managers have already employed this structure.

Summarized in the accompanying chart are the key differences between a Section 457A compliant plan with a SROF and an option or rights structure.

Short-Term Deferral Exception

Note there is an additional planning consideration that provides for the deferral of management and/or performance fees (but not a carried interest) for cash basis managers. Under the exception to the general rules of Section 457A, a cash basis manager can defer receipt of income and defer payment of tax as long as the cash is received no later than the 15th day of the third month after the end of the taxable year (generally referred to as the two-and-a-half month rule), and tax on such income is paid in that year.

If the fund/fee payer is on an accrual basis, it can deduct the fee in the year earned if it is accrued at year end and paid within two-and-a-half months of year-end. If the fund/fee payer is on a cash basis itself, it won't be

able to deduct the fee until paid (Section 457A(d)(3)(B); see also Treas. Reg. Section 1.409A-1(b)(4)).

In an environment when tax rates may be reduced in the next year, this short-term deferral election may provide permanent tax savings. The election to use the short-term exception should be made before the period during which services are to be performed begins. Managers should review what deferral opportunities are available under their agreements. Such an election should be made in writing, a copy given to the service recipient (the offshore fund), and placed in the manager's books and records.

	457A Compliant Plan	**Option/Rights**
Manager on Cash Basis	Yes	Not necessary
Deferral of income	Yes, through SROF plus 12 months after the end of the year in which the SROF is met.	Yes
Cumulative return/ clawback	No, but can provide for cumulative	Yes
20% penalty tax for plan failure?	Possible, depending on how the plan calculates payments	No
Can be used for performance and management fees?	Yes	Yes

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