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Impact of Revenue Ruling 2014-18 on compensation of hedge fund managers and employees

June 24, 2014

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Background

Deferred fees

Section 409A – 2004

Section 457A – 2009

Incentive Allocations

Deferred Fees

- Most hedge managers with offshore funds deferred their fees
- Typical period was for 10 years

Section 409A

- Enacted in 2004
- Placed restrictions/requirements on nonqualified deferred compensation (“NQDC”)
- NQDC included deferrals by hedge fund managers
- IMAs were revised to included certain language/restrictions in order to avoid Section 409A penalty
- Potential penalty of 20% on income, not on amount of tax

Section 457A

- Eliminated deferrals for periods after 2008
- Exception for 1 year deferrals, but rarely used in hedge fund world
- Practitioners generally were not comfortable using a substantial risk of forfeiture where the manager set up the offshore fund
- If 457A applies, deferral will generally fail. If amount of deferred compensation not “determinable,” taxation delayed until it is “determinable” plus a 20% penalty (on income, not amount of tax) applies
- Existing deferrals, grandfathered, taxed by 2017

Incentive Allocations

- Due to no longer being able to defer fees, most managers switched to incentive allocations from incentive fees
- Via master-feeder structures or mini-master structures
- Benefits: underlying character of income flow through to manager; deferral to the extent unrealized income; avoid New York City unincorporated business tax ("UBT")

Multi-Year Compensation

- Increasingly, although still a very small minority, managers are receiving multi-year compensation
- Typically, multi-year incentive allocations, where after-tax amount can be clawed back
- Multi-year compensation for employees is more common with hedge fund managers
- Typically, compensation is paid over a number of years or after-tax amounts are required to be reinvested in domestic funds and forfeited if cease being employed before a certain time

Stock Appreciation Rights (aka SARs)

- Have been considered over the years prior to and after the enactment of Section 457A
- e.g., “Keysops,” “fund appreciation rights”
- Practitioners generally were not comfortable with the use of options or SARs after the enactment of Section 457A. Deferral fails (or 20% penalty on gross amount) if wrong
- “Smelled” like deferring even though very different economically
- Technically, appeared to work

Rev. Rul. 2014-18

- Important new IRS ruling issued on June 10, 2014
- Little new law. Clarifies IRS's view though, including regarding redemption rights.
- Bottom line – Allows the use of nonqualified stock options and SARs which must be settled in stock of the service recipient. Both SARs and stock options must have an exercise price that is at least equal to the fair market value on date of grant.

- Supposedly was pushed by certain tax-exempt investors in funds which wanted to more closely align hedge fund manager compensation over time with the interests of investors
- Effectively allows a modified form of deferral
- Some key differences from deferral as managers historically know it
- Biggest difference is clawback effect
- Managers would be taxed on exercise. Income would be characterized as ordinary income

Example of Clawback:

- Deferred fees

  Year 1 – $100 million fund, fund appreciates $50 million, incentive fee is $10 million

  Year 2 – fund depreciates $50 million; deferred fee is valued at $6.67 million

- SARs

  Year 1 – $100 million fund, fund appreciates $50 million, SAR is valued at $10 million

  Year 2 – fund depreciates $50 million, SAR is valued at $0

Observations Regarding SARs

- Complicated to implement and administer
- Weigh SARs versus incentive allocation
- Character of underlying income, anticipated rate of return, anticipated tax rates
- Will investors “demand”/“request” it?
- Cannot do for domestic funds with taxable investors
- Should not do for offshore funds with taxable investors who make qualified electing fund (“QEF”) elections; possibly could work with different share classes
- Applies to cash-basis and accrual-basis managers
- SARs (for corporations) appear more preferable than options
- Need additional grants each year for prior year net increase

Timing

- For new offshore funds, could implement on formation
- For existing funds, for new investments by existing investors or new investors, could implement now
- For existing funds, existing investments, would probably implement as of January 1, 2015

Potential Benefits

- Allows ability to “defer”
- Might attract investors to a fund where incentive compensation is based on performance over time
- Deferral can basically be terminated when choose to exercise SAR (e.g., for employee compensation or after restricted period lapses)
- Investors may want SARs to not be exercisable for a fixed period of time; for example, 3 years
- Could do back-to-back “deferrals” with employees
- Could use a fiscal year other than the calendar year (e.g., June 30th)
- Could use if carried interest taxation is changed
- May be able to negotiate higher incentive percentage for agreeing to determination of incentive over a longer period of time

Potential Detriments

- Clawback effect could be a real economic detriment
- “Deferral” may be less beneficial on an after-tax basis
- Complicated to implement and administer
- Have to revise fund documents
- SARs have to be stock settled. Subject to same redemption terms of shares in fund; would own shares
- Significant PFIC issues
- Politics; will law be changed due to “deferrals”?

What impact will Rev. Rul. 2014-18 have on the hedge fund industry?

- Too early to tell
- Could have a very significant impact
- Current high tax rates may encourage deferral
- Main issue could be economics. Will investors demand? Will managers want to defer?

Questions?

Thank you for attending

Please contact us with any questions

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