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Investment Fund Managers' Use of Stock Options and Stock Appreciation Rights Under Section 457A in the Wake of Revenue Ruling 2014-18

Recently issued Revenue Ruling 2014-18 opens the door for fund managers to use Stock Rights to achieve a range of goals varying from accommodating investor demands for multi-year incentive arrangements to achieving tax deferral in fund-manager compensation arrangements. The Ruling should offer fund managers more flexibility in structuring tax-efficient compensation arrangements, but they should be wary of the inherent clawback.

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Revenue Ruling 2014-18 (the "Ruling"), released by the Internal Revenue Service in June 2014, holds that nonstatutory stock options (NSOs) and physically settled stock appreciation rights (SARs, and, together with NSOs, "Stock Rights") are not nonqualified deferred compensation plans under Section 457A.[1] NSOs are options on shares of stock that are not governed by Sections 421–424.[2] They may be settled by either (1) purchase of the stock at the exercise price or (2) a net settlement in either cash or shares of stock.[3] SARs are rights to the appreciation on shares of stock and may be settled in cash or in shares representing the amount of such appreciation. However, as further described below, the Ruling requires physical settlement for Section 457A purposes.

The Ruling should provide managers of investment funds with more flexibility to structure tax-efficient compensation arrangements with their offshore funds and tax-exempt investors. This article examines the Ruling and discusses various types of potential compensation arrangements using Stock Rights, and the tax and economic consequences thereof, in light of the Ruling.

BACKGROUND ON TAXATION OF DEFERRED COMPENSATION

Generally, Sections 409A and 457A limit a service provider's ability to defer the recognition of income for tax purposes under deferred compensation arrangements. Deferred compensation is compensation to which a service provider has a legally binding right in a taxable year but that is paid or may be payable to the service provider in a later taxable year.[4]

Under Section 409A, a service provider may defer the recognition of income with respect to a "nonqualified deferred compensation plan" (i.e., a deferred compensation plan other than a qualified plan such as a pension plan or Section 401(k) plan)

[1] All Section references made herein are to the Internal Revenue Code of 1986 (the IRC), as amended, or the Treasury Regulations promulgated thereunder, unless explicitly stated otherwise.

[2] See Treas. Reg. § 1.409A-1(b)(5); IRC § 424(c)(3)(B).

[3] Net settlement means that the exercise price is not transferred and the option holder receives a net amount in cash or shares representing the in-the-money portion of the option.

[4] Treas. Reg. § 1.409A-1(b)(1).

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so long as such plan meets certain distribution timing, anti-acceleration, and election timing requirements.[5] If a nonqualified deferred compensation plan fails to meet any of the foregoing requirements, the service provider must immediately recognize as income the entire amount of the deferred compensation, and will be subject to a penalty tax equal to 20 percent of the amount of the deferred compensation and interest.[6]

Section 457A, which was enacted in 2008, greatly restricts the ability of service providers to defer compensation from certain tax-indifferent service recipients (known under Section 457A as "nonqualified entities"), such as certain foreign-domiciled funds. Generally, Section 457A applies to compensation that is deferred under a "nonqualified deferred compensation plan" of either:

- *A foreign corporation*, unless substantially all of its income is (1) effectively connected with the conduct of a trade or business in the United States, or (2) subject to a comprehensive foreign income tax; or

- *Any partnership*, unless substantially all of its income is allocated to persons other than (1) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, or (2) tax-exempt organizations.[7]

For these purposes, the term "nonqualified deferred compensation plan" has the same meaning as under Section 409A, except that such term 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 (i.e., SARs).

Once compensation under any such plan is no longer subject to a "substantial risk of forfeiture" (meaning the service provider must continue to provide services through the date of payment),[8] such compensation is includible in the gross income of the service provider.[9] If the amount of such compensation is not determinable at the time it would otherwise be taken into account, it must be taken into account when it becomes determinable, and an additional tax in the amount of 20 percent of the compensation will be imposed, as well as an interest charge.[10] The Internal Revenue Service (IRS) has interpreted Section 457A to apply to both cash and accrual method taxpayers.[11]

FUND MANAGER COMPENSATION PRIOR TO SECTION 457A

A typical hedge fund is structured with three entities. The trading vehicle (called the "Master Fund") is an entity domiciled in a low- or no-tax jurisdiction (e.g., the Cayman Islands, Bermuda, the British Virgin Islands) and classified as a partnership for U.S. tax purposes. The Master Fund has two members, a Delaware LP or LLC (the "Onshore Fund"), which is classified as a partnership for U.S. tax purposes, and another foreign entity (the "Offshore Fund"), which is domiciled in the same jurisdiction as the Master Fund but is classified as a corporation, rather than a partnership, for U.S. tax purposes. The Onshore Fund generally accepts investments only from U.S. taxable investors; the Offshore Fund generally accepts investments only from non-U.S. investors and U.S. tax-exempt investors.

A variation of the Master Fund structure is the so-called parallel fund structure. The parallel structure does away with the Master Fund; instead, the Onshore Fund and the Offshore Fund trade in the same investments on a parallel basis through their own prime broker accounts. Some fund structures also consist of a single fund, which may be either an Onshore Fund or an Offshore Fund depending upon the strategy and type of investor.

The fund manager is typically a U.S. entity that is a partnership for tax purposes (or, less often, an S corporation). The fund manager is usually compensated by receiving both a management fee (based upon the amount of assets under management) and also incentive compensation (based upon net profits, realized and unrealized).

Fund managers typically are due a management fee from both the Onshore Fund and Offshore Fund on a monthly or quarterly basis. The incentive compensation, which is usually determined annually on an investor-by-investor basis, was usually structured differently for the Onshore Fund and the Offshore Fund prior to the enactment of Section 457A. Incentive compensation was taken from the Onshore Fund as a partnership profit allocation or "carried interest" so that the fund manager could potentially receive favorable tax rates to the extent that underlying income consisted of long-term capital gains or qualified dividends. To receive compensation in this

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[5] See IRC § 409A(a)(2)-(4).

[6] IRC § 409A(a)(1).

[7] IRC § 457A(b).

[8] IRC § 457A(d)(1)(A).

[9] IRC § 457A(a).

[10] IRC § 457A(c). See Notice 2009-8, Q&A-19(b) for a discussion regarding when amounts are considered to be not determinable.

[11] Notice 2009-8, Q&A-5.

manner, the fund manager must be an equity owner of the Onshore Fund.[12] Incentive compensation from the Offshore Feeder was paid as a fee. This incentive fee, along with the management fee due from the Offshore Fund, could, pre-Section 457A, be deferred (in whatever percentage desired), allowing the manager to avoid current taxation. In addition, this allowed the fund manager to reinvest the deferred fee back into the Offshore Fund on a pre-tax basis. When finally paid, this deferred compensation was taken into account as ordinary income. Because most Offshore Funds pay little or no taxes, this conveyed an enormous timing benefit upon fund managers. The only constraints upon fund managers were those imposed by Section 409A and the principles of constructive receipt.

In this compensation arrangement, once incentive compensation is received or accrued by the manager, it is not given back in subsequent years—even if there are subsequent losses that bring investors into an overall loss position. For example, if a fund is up $1,000 in Year 1, up $500 in Year 2, and down $2,000 in Year 3, the manager is still entitled to the $300 of incentive compensation it earned (assuming a 20 percent incentive rate) in Years 1 and 2. This lock-in effect caused some large investors to negotiate alternative compensation arrangements.

These alternative compensation arrangements usually consisted of some form of multi-year determination period, often two, three, or even five years. So, in the example in the preceding paragraph, the fund manager would have not been entitled to any incentive compensation if the determination period were three years rather than annual. This inherent "clawback" more closely aligns the interests of managers and their investors. Not surprisingly, these arrangements are less popular among fund managers than among investors.

FUND MANAGER COMPENSATION AFTER SECTION 457A

Section 457A eliminated the ability of managers to defer management and incentive fees with respect to Offshore Funds. Thus, post-Section 457A, fund managers take different approaches to incentive compensation from their Offshore Funds depending upon their investment strategies. For strategies that are expected to generate long-term capital gains, fund managers take the incentive compensation with respect to their Offshore Funds as a partnership profit allocation in the same manner as from their Onshore Funds. These profit allocations are taken at either the Master Fund level or from another entity taxed as a partnership that is either set up between the Master Fund and the Offshore Fund, or set up below the Offshore Fund in the case of a parallel or stand-alone structure. Other fund managers that do not expect to generate long-term capital gains simply receive and take an incentive fee into account annually. Management fees are taken into account when paid or accrued.

In addition to eliminating the typical deferred compensation arrangement discussed above, which primarily had the goal of achieving tax benefits for fund managers, the enactment of Section 457A also made multi-year incentive arrangements tax inefficient with respect to the compensation of fund managers from their Offshore Funds. Multi-year incentive arrangements run afoul of Section 457A because the compensation paid at the end of the determination period is partially attributable to services performed in an earlier year, even though the end of the period would normally be much shorter than the deferral period under a pre-Section 457A plan, which was often as much as 10 or even 15 years. In addition, because the compensation is indeterminate, the Section 457A penalty taxes and interest would be imposed when such amounts are finally paid to the fund manager. This is an unfortunate and possibly unintended consequence of Section 457A because, unlike the typical deferred compensation arrangement, multi-year incentive arrangements are usually sought by investors for non-tax business reasons.

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The primary solution to this problem has been to take the incentive compensation from the Offshore Fund as a partnership profit allocation, as was being done with the Onshore Fund. Since, as mentioned above, this strategy needs a tax partnership to be implemented, the Offshore Fund compensation is taken at the Master Fund level or, if the Offshore Fund is parallel or stand-alone, from a partnership entity formed below the Offshore Fund. Partnership profit allocations are not subject to Section 457A. However, because of the partnership accounting rules, the accrued incentive compensation is allocated and taxed to the fund manager on an annual basis, even though it has not crystallized and is subject to clawback in later years. Therefore, most fund managers negotiate a current tax distribution to give them the cash to pay their annual income taxes. If, ultimately, there is a clawback the investors typically bear the cost of the tax

[12] Often the fund manager will set up a separate pass-through entity with the same ownership to receive this profit allocation.

distribution.[13] In the end, this only partially achieves the investors' goals of not giving up any value to the fund manager unless the manager performs positively over a multi-year period.[14]

TREATMENT OF STOCK RIGHTS UNDER SECTION 457A

Section 457A on its face is silent on whether NSOs are part of a nonqualified deferred compensation plan, but it does provide that SARs would be.[15] However, Notice 2009-8,[16] which was released shortly after the enactment of Section 457A, specifically excludes from the definition of a nonqualified deferred compensation plan:

- *At or out-of-the-money (as of grant date) NSOs* for a fixed number of shares of service recipient stock that carry no deferral feature other than the deferral of recognition of income until the later of the exercise or disposition of the option or the time the stock acquired pursuant to the exercise of the option first becomes substantially vested; and

- *Service recipient stock settled SARs* that limit the stock compensation payable under such rights to the excess of the fair market value of a fixed number of shares of service recipient stock on the date of exercise over the SAR exercise price, which price is not less than the fair market value of such shares as of the grant date.[17]

Even with the guidance provided by Notice 2009-8, most tax advisors were unable to get comfortable with fund managers using Stock Rights as alternative compensation with respect to their Offshore Funds. The concern was that plans using Stock Rights would simply be too close to the type of deferral arrangements that Congress had just prohibited with the passage of Section 457A, which was aimed at fund managers.

In light of Notice 2009-8, some fund investors wanted fund managers to start using Stock Rights to achieve the multi-year incentive compensation arrangements that Section 457A had made problematic. It just so happened that the enactment of Section 457A occurred around the same time as the credit crisis, and, due to some big losses suffered, investors also were seeking to better align their interests with those of fund managers. Others in the industry were touting the use of Stock Rights as a way for managers to achieve tax deferral similar to the pre-Section 457A deferral arrangements.

Ultimately, even with the guidance provided by Notice 2009-8, most tax advisors were unable to get comfortable with fund managers using Stock Rights as alternative compensation with respect to their Offshore Funds. The concern was that plans using Stock Rights would simply be too close to the type of deferral arrangements that Congress had just prohibited with the passage of Section 457A, which was aimed at fund managers. As a result, there have been very few fund manager compensation arrangements undertaken with Stock Rights. Instead, the market more or less settled on using the imperfect profit allocation arrangement described above for multi-year incentive arrangements, and all but abandoned the idea of resurrecting tax-deferral arrangements. Sometimes lost in this discussion was that the economics of a Stock Rights compensation arrangement are very different from the economics of a pre-Section 457A deferred compensation arrangement due to the inherent clawback in the Stock Rights. This will be further discussed and illustrated below.

REVENUE RULING 2014-18

Facts of the Ruling. In June of 2014, Revenue Ruling 2014-18 was released. The Ruling holds that Stock Rights on the common shares of a nonqualified entity do not constitute a nonqualified deferred compensation plan under Section 457A.

Under the Ruling, the service recipient, a tax-indifferent entity classified as a corporation for U.S. tax purposes, grants to the service provider, as incentive

[13] This is because the amount of the clawback is usually limited to the amount of the fund manager's carried interest minus the amount of taxes paid with respect to such carry (which is paid with a tax distribution).

[14] When the fund manager finally pays the clawback, it will obtain a tax deduction. This means that the manager effectively has received a net tax deduction without putting up any of its "own" money (since the clawback is paid with a carried interest amount that the manager was not ultimately entitled to). Some investors are able to negotiate being paid an additional amount to the extent that the fund manager actually gets a tax benefit, but fund managers usually resist this because of problems determining whether the benefit actually occurred.

[15] IRC § 457A(d)(3)(A). Arguably, IRC § 457A would have permitted NSOs that are allowed under IRC § 409A in light of IRC § 457A's cross reference to IRC § 409A(d). IRC § 457A(d)(3)(A).

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

[17] Notice 2009-8, Q&A-2(b) and Treas. Reg. § 1.409A-1(b)(5)(i)(B).

compensation, Stock Rights with respect to the service recipient's common shares. Each Stock Right has an exercise price per share that is not less than the fair market value of a common share of service recipient stock on the date of grant. The Stock Rights do not include any feature for the deferral of compensation until the later of exercise (or disposition) of the option or the time the stock acquired on exercise of the option becomes subject to vesting, and the Stock Rights otherwise comply with the requirements of Treasury Regulation Section 1.409A-1(b)(5)(i)(A).[18] Stock Rights that are SARs must be, and are actually, settled in stock of the service recipient (rather than in cash). The 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 the service recipient.

Logic. The logic of the Ruling is fairly straightforward. Section 457A(d) refers to Section 409A in defining a nonqualified deferred compensation plan. Section 409A provides that an NSO to purchase a fixed number of shares of service recipient stock does not provide for the deferral of compensation if the exercise price is not less than the fair market value of the underlying stock on the date the NSO is granted, the stock option does not include any feature for the deferral of compensation, and the other requirements of Treasury Regulation Section 1.409A-1(b)(5)(i)(A) are met. Therefore, NSOs that meet these Section 409A requirements should also be exempt from Section 457A. The Ruling also exempts SARs, which are explicitly prohibited by the terms of Section 457A, reasoning that physically settled SARs are functionally identical in all material aspects to NSOs to purchase service recipient stock with a net exercise feature and therefore, to the extent that NSOs are exempt from section 457A, functionally identical SARs should also be exempt.

OTHER LEGAL ISSUES RELATED TO STOCK RIGHTS PLANS

There are some other legal issues to be considered with respect to Stock Rights plans that are not addressed by the Ruling.

Common Stock. For one, the Stock Rights must be with respect to common stock. The Ruling is based on Treasury Regulation Section 1.409A-1(b)(5)(i), which applies only to common stock as defined in Section 305.[19] Under Section 305, common stock is any stock that is not preferred stock. The distinguishing feature of preferred stock for the purposes of Section 305 is that its preferences are limited (usually to certain priorities with respect to dividends and liquidation) and it does not participate in corporate growth to any significant extent.[20] Since investors in most funds participate in fund growth to an unlimited extent (other than the incentive compensation to the fund manager) there should be little trouble concluding that such investors hold common stock.

PFICs and Section 83. The rules governing passive foreign investment companies (PFICs) and the intersection of those rules with Section 83 must also be considered. Almost all Offshore Funds are PFICs for tax purposes, which means that fund managers receiving stock on the exercise of a Stock Right will become holders of stock in a PFIC. Special rules apply to U.S. holders of PFIC stock to curtail the ability of such a holder to defer passive income earned by the PFIC. Generally, the PFIC regime requires a U.S. holder to elect to include the passive earnings annually (a so-called "QEF" election) or imposes an interest charge on "excess distributions" from the PFIC or upon the ultimate disposition of the PFIC shares. The interest charge is applied as if the excess distribution or gain were recognized on a straight-line basis over the investment holding period of the PFIC shares. For PFIC shares that are publicly traded (which most investment funds are not), a holder may alternatively elect to mark the shares to market on an annual basis.

> **Almost all Offshore Funds are PFICs for tax purposes, which means that fund managers receiving stock on the exercise of a Stock Right will become holders of stock in a PFIC, and special rules apply to U.S. holders of PFIC stock to curtail their ability to defer passive income earned by the PFIC.**

An option to acquire PFIC shares is treated as the holding of PFIC shares for certain purposes, including that an option to acquire PFIC stock will be treated as PFIC stock in applying the PFIC interest charge rules to a disposition of the stock.[21] However, for these purposes, the exercise of an option is not a

[18] The only other requirement is that the transfer or exercise of the option be subject to taxation under IRC § 83 and Treas. Reg. § 1.83-7. Treas. Reg. § 1.409A-1(b)(5)(i)(A)(2).

[19] Treas. Reg. § 1.409A-1(b)(5)(iii).

[20] Treas. Reg. § 1.305-5(a).

[21] Prop. Treas. Reg. § 1.1291-1(d).

disposition to which the PFIC rules apply.[22] The upshot of this is that a fund manager would not trigger gain for purposes of the PFIC interest charge rules upon the exercise of a Stock Right; however, when the fund shares acquired pursuant to the exercise of the Stock Right are disposed of, the holding period for purposes of determining the interest charge will include the period beginning on the date of the grant of the option.

This is where Section 83 comes into the picture. Section 83 governs the transfer of property in connection with the performance of services.[23] This includes compensatory options such as stock rights. Since shares of private funds are not traded on established securities markets, a fund manager would not recognize taxable income upon the grant of Section 457A-exempt Stock Rights.[24] The fund manager's basis in the Stock Rights would be zero. Upon exercise of a Stock Right, a fund manager would include the fair market value of the Stock Right in ordinary income,[25] and would take a fair market value basis in the shares received in connection with exercise.

Since the fund manager has a fair market value tax basis in the shares as of the exercise date, the PFIC interest charge discussed above would apply only to an increase in value after the date of exercise, although for the purposes of calculating the charge that gain would be spread out over the full period including the date of the grant of the Stock Right. Therefore, most fund managers will probably want to redeem the shares received upon exercise as soon as possible after exercise.

Are there any restrictions on redeeming such shares? The Ruling says that the shares received upon exercise of the Stock Rights must have the same liquidity rights as other shareholders have with respect to their common shares of the service recipient. Presumably this means that a fund manager may redeem the shares on the next redemption date that applies to the other holders of such shares. This should probably be interpreted as including any applicable notice provisions. For instance, if a fund manager exercises a Stock Right on the last day of a calendar quarter, and there is quarterly liquidity with a 60-day notice period, then the fund manager should be able to redeem at the end of the next quarter by giving notice in the same manner as any other holder of shares. This should minimize the PFIC interest charge. It would probably not be advisable to attempt to give notice of redemption prior to the time of actually acquiring the shares pursuant to exercise in an attempt to redeem immediately upon exercise, as this would arguably give the Stock Rights different liquidity rights than the other shareholders.

STRUCTURING STOCK RIGHTS ARRANGEMENTS AFTER THE RULING

Accordingly, after the Ruling, it appears that fund managers should be able to use Stock Rights to structure incentive compensation arrangements. Most of these plans would likely involve SARs rather than NSOs, as fund managers presumably will not want to actually put up the cash to buy shares on exercise.

The mechanics of such a plan might work as follows. Assume 10 investors who each invest $1,000 in an offshore fund, for a total of $10,000. Each investor is issued 10 shares worth $100 apiece. The fund manager wants a 20 percent incentive and therefore is granted a SAR on the appreciation of 20 shares, or 2 shares per investor. Assume the multi-year incentive period is three years. At the end of Year 3, the manager will be granted stock equal to the appreciation on 20 shares. So, if the fund value rises from $10,000 to $15,000 over the three years, the fund manager would exercise the SAR at the end of the three-year period and be granted shares with a value of $1,000 (i.e., the $5,000 overall appreciation, divided by 100 (the total number of all shares), multiplied by 20). Investors could be required to stay in the fund for the full three-year period or, alternatively, the terms of the plan could provide for an earlier exercise with respect to a departing investor's shares upon redemption.

It might also be possible for a fund manager to attempt to replicate, at least partially, pre-Section 457A tax deferral. This could be done by granting additional Stock Rights every year on each investor's net profits for such year. As with pre-Section 457A arrangements, incentive compensation would be determined annually rather than over a multi-year period. To illustrate, in the example above, if the $5,000 profit took place in the first year, the fund manager would also be granted SARs on 20 percent of the future appreciation of that $5,000. This would give the manager the effect of reinvesting its appreciation into the fund on a pre-tax basis, as happened with the pre-Section 457A plans. Since the Ruling requires that Stock Rights be issued with respect to a fixed number of shares, the mechanics of this could be a bit messy, and might require yearly recapitalizations, share divisions, the issuance of additional shares to investors, and the like. However, there appears to be no reason that this could not

[22] Prop. Treas. Reg. § 1.1291-1(d).

[23] See IRC § 83(a).

[24] Treas. Reg. § 1.83-7(a).

[25] Treas. Reg. § 1.83-7(a).

be done. Nonetheless, as will be illustrated in more detail below, such a plan would not exactly replicate pre-Section 457A deferral due to the inherent clawback in Stock Rights.

ECONOMICS OF STOCK RIGHTS INCENTIVE ARRANGEMENTS

At this point, it might be helpful to examine a few different compensation arrangements with respect to Offshore Funds in more detail. The four different scenarios set forth below all share the following assumptions:

- Offshore Fund;
- $100 invested at the beginning of Year 1;
- 20 percent incentive compensation rate;
- Five-year period;
- No redemptions;
- Performance: Year 1, + 100 percent; Year 2, + 100 percent; Year 3, + 100 percent; Year 4, – 50 percent; Year 5, + 100 percent.

Scenario 1: Annual Incentive Fee; No Deferral. Table 1 presents the five-year financial picture for a compensation arrangement that calls for an annual incentive fee with no deferral. As shown, under this scenario, the fund manager has received $120 in incentive fees, even though 20 percent of the investors' net profit over the five-year period would have been only $96.80. The reason this occurred is because the fund manager was able to take out its incentive on an annual basis regardless of what happened in later periods, illustrating the lock-in effect discussed above.

Scenario 2: Annual Incentive Fee; Deferral. Table 2 shows the five-year financial picture for a compensation arrangement that calls for an annual incentive fee with deferral. This table illustrates the compounding effect that the fund manager gets from reinvesting its incentive back into the fund. The reinvestment is pre-tax, because no tax is due on any amount until such amount is paid to the fund manager in accordance with the terms of the deferred compensation plan. In Year 4, when the fund suffers a loss, the fund manager also suffers a loss to the extent of its reinvested incentive compensation—but, because of the lock-in effect, the fund manager does not give up any incentive that has previously accrued, even

Table 1: Five-Year Results for Scenario 1

	Beg. Y1	End Y1	End Y2	End Y3	End Y4	End Y5
Assets Under Management (AUM)	$100	$200	$360	$648	$292	$584
Profit(Loss)	—	$100	$180	$324	$(292)	$292
Noncumulative Incentive Fee(1)	—	$20	$36	$64	$0	$0
Investor Net Profit (cumulative)	—	$80	$224	$484	$192	$484
Beg. Next Year AUM	—	$180	$324	$584	$292	$584
Total Investor Capital Upon Redemption	—	$180	$324	$584	$292	$584

(1) Fee is paid to manager every year.

Table 2: Five-Year Results for Scenario 2

	Beg. Y1	End Y1	End Y2	End Y3	End Y4	End Y5
AUM	$100	$200	$400	$800	$400	$800
Profit(Loss)	—	$100	$200	$400	$(400)	$400
Cumulative Incentive Fee(1)	—	$20	$76	$216	$108	$216
Investor Net Profit (cumulative)	—	$80	$224	$484	$192	$484
Beg. Next Year AUM	—	$200	$400	$800	$400	$800
Total Investor Capital Upon Redemption	—	$180	$324	$584	$292	$584

(1) This amount is cumulative and includes the growth on prior incentive compensation plus new incentive compensation. For instance, the $76 in Year 2 represents the 100 percent growth of the manager's $20 incentive from Year 1 plus an additional grant for Year 2 of $36 (i.e., 20 percent of the $180 growth attributable to the investor's end-of-Year 1 capital).

though the underlying growth that generated that incentive has been reversed.

Scenario 3: Multi-Year Incentive Compensation With Stock Rights. Table 3 shows the five-year financial picture for a compensation arrangement that calls for a multi-year incentive arrangement using Stock Rights. In this scenario, the fund manager receives total incentive compensation of $140, which is equal to 20 percent of the investors' overall net profits of $700 over the five-year period. The fund manager is worse off here than in Scenario 2, because the fund manager has not been able to lock in prior incentive. However, the fund manager has been able to remain exposed to the overall profitability of the fund and thus comes out ahead of Scenario 1 (unless the fund manager would have been able to earn a better return on the amounts paid out to it in Scenario 1).

Scenario 4: Additional Stock Rights Granted on Each Year's Growth. Table 4 shows the five-year financial picture for a a Stock Rights compensation arrangement with additional Stock Rights being granted each year on that year's growth. This scenario comes very close to replicating the pre-Section 457A deferred compensation arrangement illustrated by Scenario 2; in both, the fund manager ends up with $216 in total incentive compensation. The key difference is in Year 4, after the 50 percent loss from Year 3. If the fund would have wound up then, or else not returned to profitability, the fund manager would have only received $76 in total compensation in Scenario 4. In contrast, in Scenario 2 the fund manager would have received a total of $108. The reason for this is that in Scenario 4 there was a $32 clawback in Year 4. It is only because of the recovery in Year 5 that both the fund manager and the investors end up in the same place. In addition, in Scenario 4 the fund manager has gotten a greater compounding effect than in Scenario 3, due to the growth on growth. Accordingly, the investors are better off in Scenario 3 to the same extent that the fund manager is better off in Scenario 4.

CONCLUSION

In the wake of the Ruling, fund managers should be able to use Stock Rights to achieve a range of goals varying from accommodating investor demands for multi-year incentive arrangements to achieving tax deferral. However, fund managers must be wary of the inherent clawback in these arrangements, and should understand that the results of pre-Section 457A deferral arrangements cannot be precisely replicated in every scenario.

Table 3: Five-Year Results for Scenario 3

	Beg. Y1	End Y1	End Y2	End Y3	End Y4	End Y5
AUM	$100	$200	$400	$800	$400	$800
Profit(Loss)	—	$100	$200	$400	$(400)	$400
Cumulative Incentive Fee(1)	—	$20	$60	$140	$60	$140
Investor Net Profit (cumulative)	—	$80	$240	$560	$240	$560
Beg. Next Year AUM	—	$200	$400	$800	$400	$800
Total Investor Capital Upon Redemption	—	$180	$340	$660	$340	$660

(1) At any time, this simply represents 20 percent of AUM growth.

Table 4: Five-Year Results for Scenario 4

	Beg. Y1	End Y1	End Y2	End Y3	End Y4	End Y5
AUM	$100	$200	$400	$800	$400	$800
Profit(Loss)	—	$100	$200	$400	$(400)	$400
Mgr Cumulative Incentive	—	$20	$76	$216	$76	$216
Investor Net Profit (cumulative)	—	$80	$224	$484	$224	$484
Beg. Next Year AUM	—	$200	$400	$800	$400	$800
Total Investor Capital Upon Redemption	—	$180	$324	$584	$324	$584

To date, the market does not seem to have embraced the use of these Stock Rights. Perhaps that is because they are not yet well understood, or maybe fund managers understand all too well the potential negative consequences of these arrangements. The goal of this article is to enhance the ability of fund managers and investors alike to evaluate the tax issues and economic consequences of the use of Stock Rights for incentive compensation arrangements. Whether such arrangements will become more common in the future only time will tell. ■