The End is Near: Repatriation of Offshore Deferred Compensation by End of 2017

INTRODUCTION
Hedge fund managers (and other taxpayers) could be facing significant tax bills in 2018. This potential tax liability does not arise from trading gains or some new tax law, but rather has its roots in a nearly decade-old tax change. As part of the Emergency Economic Stabilization Act of 2008, Congress added a new section (457A) to the Internal Revenue Code on October 3, 2008. This section restricts the use of deferred compensation sponsored by a non-U.S. entity. It also requires deferred compensation arrangements already in place (so-called grandfathered deferrals) to end by December 31, 2017, unless those deferrals are otherwise still subject to a substantial risk of forfeiture. While this tax law does not target hedge fund managers specifically, they are likely caught in its cross-hairs because U.S.-based hedge funds often compensated their managers with offshore deferred compensation before section 457A was enacted. The purpose of this Alert is to briefly describe the tax law, explain some of its consequences and to discuss, in very broad terms, possible planning techniques that might be used to offset the tax liabilities that will necessarily accompany compliance with this law.

BACKGROUND
The landscape
Historically, hedge funds have been structured in a way that its managers derive a significant portion of their compensation from related offshore entities. There are various reasons offshore entities are used (the reasons are beyond the scope of this Alert, but generally, offshore funds are created to allow U.S. corporations and U.S. charitable organizations to invest without being subjected to unnecessary taxes). As performance fees were earned, the fund managers often chose to leave some portion of their compensation in the offshore entity, to be paid to them at some later date instead of on a current basis. The deferred funds would grow generally tax-free until paid many years later to the fund manager.

Official government estimates from the Joint Committee on Taxation (at the time 457A was first adopted) suggested that the amounts held in these arrangements amounted to many billions of dollars, which effectively represents about $25 billion in deferred tax revenue. Unofficial estimates and recent articles suggest that most fund managers have not yet repatriated their previous deferrals, and with tax-deferred growth over the past ten years, the amounts still held in deferred offshore funds are so significant that the collective tax revenue could be multiples of the previously estimated $25 billion – perhaps exceeding $100 billion.¹

 Brief description of IRC 457A
The 2008 law generally disallows any long-term deferral of compensation by U.S. persons for services performed for a non-U.S. entity that is not subject to income taxation.² The 2008 law applied immediately to any

¹ “Painful Date With Tax Man Looms for Top US Hedge Funds,” June 21, 2016, Bloomberg News.
² Section 457A provides in part: “Any compensation which is deferred under a nonqualified deferred compensation plan of a nonqualified entity shall be includible in gross income when there is no substantial risk of forfeiture of the rights to such compensation.” As with many complex tax laws, details matter. The details begin with defining terms like “nonqualified deferred compensation”, “nonqualified entity” and “substantial risk of forfeiture.” Embedded within those definitions are...
compensation related to services performed after December 31, 2008. A special grandfathering rule applied to deferrals attributable to services performed before January 1, 2009 and not subject to substantial risk of forfeiture. The owners of such prior deferred compensation were given a nine year transition period ending on December 31, 2017, within which to “repatriate” those assets by recognizing their value as taxable income. In addition to regular federal income taxes, a 20% federal tax surcharge plus interest is charged on deferrals that do not comply with 457A.

Consequences of Anti-Deferral Law

The main consequence of the change in law was that starting with tax year 2009, fund managers would no longer be able to defer compensation in the same manner as they had been doing (but could continue to defer compensation on a short-term basis: generally twelve months or less). The more relevant consequence for longtime fund managers is that the entire balance in deferred offshore funds would have to be repatriated and subjected to income tax by the end of 2017. While the law does not literally require that offshore deferred compensation accounts must be repatriated, the only way to avoid such repatriation is to recognize the federal, state and local income tax as if the funds were repatriated.3

THE END IS NEAR - POTENTIAL PLANNING TO AMELIORATE THE TAX BURDEN OF REPATRIATION

As 2017 draws to a close, many fund managers have been waiting for a “silver bullet” solution to make their potential tax problems go away. There is none. As a result, many fund managers face a very substantial tax bill resulting from the repatriation of assets that were held in offshore deferred compensation accounts. Most planning has focused on ways to generate deductions or losses to “offset” the income to be recognized by year-end. Some of the planning that fund managers may want to explore before year end include:

- **Change of Tax Domicile**: Some fund managers may consider changing their state tax domicile from a high-tax to a low- or no-tax jurisdiction. Many states, such as New York and Connecticut, have rules that would source the income back to their state (where the income was earned), but not all states have such rules. Generally, changing tax domicile is a decision that is made well before the year the income is to be recognized.

- **Generating Ordinary Losses**: It is possible that some fund managers are in a position to generate (or accelerate) some amount of “ordinary tax losses.”4 These losses could then offset the ordinary income from deferred compensation income on a dollar-for-dollar basis.

- **Direct Charitable Gifts**: Direct charitable gifts made to a public charity, donor advised fund or private family foundation. The advantage of a direct charitable gift is that the fair market value of the gift can generally offset all or a portion of the repatriated income.5 The major disadvantage is that not all of a

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3 Even after paying required income taxes, any assets not actually repatriated to the U.S. (and thus remaining offshore) could be subject to the so-called Personal Foreign Investment Company (PFIC) rules. It is beyond the scope of this Alert to explain what a PFIC is or how it operates. There is a general consensus that U.S. shareholders of PFICs face several adverse consequences as well as the complexity and scope of numerous reporting and filing requirements, which means that very few fund managers would choose this route.

4 We note that since the repatriated compensation will be ordinary income, generating capital losses from portfolio investments will not benefit taxpayers beyond a nominal $3,000 offset.

5 Charitable deductions will also be subject to the various limitations relating to adjusted gross income (AGI) depending on the type of charitable recipient and the gifted property.
taxpayer’s income can be offset and that the taxpayer must “give up” assets in order to get the
deduction. Those assets “given up” are irrevocably committed to a charitable recipient and cannot
also benefit family members.

- **Grantor Charitable Lead Annuity Trust (CLAT):** A so-called “zeroed-out” grantor CLAT is a more
sophisticated solution that could provide not only income tax benefits but possible estate planning
benefits for the family. Funding a grantor CLAT can create an income tax charitable deduction (again,
subject to AGI limitations) large enough to equal the value of the assets placed in the trust. Depending
on the investment performance of the assets in the trust, and the initial stream of payments that must
be made to the charitable organization, there may also be assets remaining at the end of the trust
term which can pass to family members. One of the perceived downsides of a grantor-CLAT is that
the creator must include all income, gains and other tax attributes of the trust on his or her personal
tax return. Therefore, there should be an emphasis on managing the trust assets in a very tax efficient
manner, or investing the assets in tax-efficient investments. Some have suggested funding the trust
with private placement life insurance to achieve greater tax efficiency. Like other tax considerations,
care must be taken that you are talking to experienced advisors and appropriate professionals, both
attorneys and accountants.

- **Pooled Income Fund:** Fund managers could consider contributions to a Pooled Income Fund (PIF).
Taxpayers who fund a PIF could get a substantial charitable deduction – a deduction equal to the
actuarial value of the PIF that will eventually pass to charity that is attributable to the value of the
assets you donate (not 100%, but depending on your age the deduction could be significant). Until
the property ultimately passes to the charitable organization (i.e. your lifetime) you can effectively
“earn” the income from the entire principal invested in the PIF.

Sometimes a single strategy is the right solution. Other times, a combination of strategies may be the better fit.
Regardless, the foregoing could go a long way toward taking some of the sting out of the tax bite.

**REPLACEMENTS FOR FUTURE DEFERRALS**

Hedge fund managers are still permitted to defer fees on a short-term basis or even on a longer basis if the deferral
is subject to a substantial risk of forfeiture. However, most deferrals will not be subject to forfeiture and therefore
must be addressed by the end of 2017. As noted, future earnings could be deferred on a short-term basis. For
those looking to defer longer term, there may be an opportunity to do so by using certain stock options or stock
appreciation rights. IRS guidance (Notice 2009-8 as amplified by Revenue Ruling 2014-18) has approved a narrow
exception to the anti-deferral rules of section 457A. For instance, if a hedge fund manager’s incentive fee were
to be paid in the form of stock options or stock-settled stock appreciation rights with a grant price equal to the
fair market value of the hedge fund shares on the date of grant, then the exercise of such options or rights could
be deferred for a number of years providing a deferral of income until exercised. The IRS determined that such
an arrangement would not rule afoul of section 457A.

**CONCLUSION**

The window for planning is drawing to a close. Unless a fund manager’s offshore deferred compensation is still
subject to a substantial risk of forfeiture, that compensation must be recognized as income by December 31, 2017
(whether by actual repatriation of the assets to the U.S. or “deemed” repatriation by paying income tax on assets
that remain offshore). While planning may not fully extinguish the 2018 tax, it could mitigate what might
otherwise be a very significant federal and state income tax bill.

-- National Wealth Planning Strategies Group
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