

# IRS issues Revenue Ruling 2014-18: Application of section 457A to certain equity arrangements

## Situation presented

Recently, the Internal Revenue Service (IRS) released Revenue Ruling 2014-18 (“the Ruling”), which provides guidance as to whether nonqualified stock options (NSOs) or stock-settled stock appreciation rights (SARs) are nonqualified deferred compensation subject to section 457A. The Ruling is consistent with our prior understanding of the exception for NSOs and SARs (discussed below), and confirms that NSOs and stock-settled SARs that satisfy certain equity exceptions under section 409A that are issued by an entity subject to section 457A to an unrelated non-individual service provider are not subject to taxation under section 457A.

## Issue

### Background

Section 457A is a provision of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Div. C of Pub. L. No. 110-343 (“TEAMTRA”), which was enacted October 3, 2008. The provision imposes more restrictive income timing rules on nonqualified deferred compensation from “tax indifferent” entities. Aimed at offshore hedge and private equity funds and at other service recipients that are not subject to U.S. income tax, section 457A requires income inclusion when there is no substantial risk of forfeiture – which exists only if the right to the compensation is “conditioned upon the future performance of substantial services.”

Section 457A generally provides that any compensation that is deferred under a nonqualified deferred compensation plan of a nonqualified entity is includible in gross income when the compensation is no longer subject to a substantial risk of forfeiture. If amounts subject to section 457A are not determinable in the year in which the substantial risk of forfeiture lapses, the amounts are includible in income when the amounts are determinable, but are subject to an additional 20 percent income tax and interest. Section 457A applies to compensation attributable to services performed after December 31, 2008. Amounts that are attributable to services before this date will become subject to the rules in 2017.

Section 457A applies to the nonqualified deferred compensation for services to a “plan sponsor” that is a nonqualified entity. For purposes of section 457A, the plan sponsor is the entity that would be entitled to a compensation deduction under U.S. principles. A nonqualified entity is generally a foreign corporation, unless substantially all of its income is subject to comprehensive foreign income tax, or a partnership that has substantially all of its income allocated to persons who are foreign persons that are not subject to a comprehensive foreign income tax and organizations that are exempt from tax under the Internal Revenue Code of 1986, as amended. The determination as to whether an entity is a nonqualified entity or a plan sponsor is made as of the last day of the service provider’s taxable year (generally December 31st).

A nonqualified deferred compensation plan for purposes of section 457A generally has the same definition as under section 409A, with some exceptions. One of the exceptions is that for purposes of section 457A nonqualified deferred compensation includes a plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient. In Notice 2009-8, the IRS provided interim guidance regarding section 457A taxation until the Department of Treasury and the IRS issues additional guidance. Q/A-2 of Notice 2009-8 provides that NSOs and stock-settled SARs that satisfy an exception under section 409A are not considered deferred compensation for purposes of section 457A. Certain advisors to hedge

funds indicated that it was unclear whether the guidance in Q/A-2 of Notice 2009-8 would apply to compensation arrangements between hedge funds and their managers. The Ruling involves equity awards provided by a service recipient to an unrelated non-individual service provider, and so should apply to such arrangements between an offshore hedge fund and its manager.

In general, NSOs to purchase "service recipient stock" are exempt from section 409A if (i) the exercise price may never be less than the fair market value (FMV) of the shares on the date of grant and the number of shares subject to the option is fixed on the original date of grant, (ii) the transfer or exercise of the option is subject to taxation under section 83 and its regulations and (iii) the option does not include any feature to defer compensation other than the deferral of the recognition of income until the later of exercise or disposition of the option or the time the stock acquired upon exercise first vests (collectively referred to as the "409A NSO Exception").

In general, SARs that provide for appreciation on service recipient stock are exempt from section 409A if (i) the compensation payable under the award cannot be greater than the excess of the FMV of the stock on the date of exercise over the amount specified on the date of grant, with respect to a number of shares fixed on or before the date of grant, (ii) the exercise price may never be less than the FMV on the date of grant and (iii) the SAR does not include any feature to defer compensation other than the deferral or recognition of income until exercise of the award (collectively referred to as the "409A SAR exception").

Service recipient stock is generally defined as common stock for purposes of section 305 and the regulations issued thereunder. Service recipient stock does not include a class of stock that has any preference as to distributions other than distributions of service recipient stock and distributions in liquidation of the issuer. While cash and stock settled SARs that satisfy the 409A SAR exception are exempt from section 409A, only stock-settled SARs that satisfy the 409A SAR exception are exempt from section 457A. Cash settled SARs are subject to section 457A, even if they satisfy the 409A SAR exception.

## **Revenue Ruling 2014-18**

The Ruling involved a service recipient and a service provider. The service recipient is a foreign corporation and a nonqualified entity for purposes of section 457A. The service provider is a limited liability company organized under state law and treated as a partnership for U.S. income tax purposes. Income of the service provider is allocated to persons subject to U.S. income tax. The service recipient and service provider are not treated as a single employer under section 414(b) or (c).

The service recipient granted to the service provider incentive compensation in the form of NSOs and SARs. The awards provide for a fixed number of common shares of the service recipient, which qualify as service recipient stock for purposes of section 409A. The exercise price of each award is not less than FMV of common shares of the service recipient on the date of grant. The awards do not include an additional deferral feature as described in section 409A and otherwise comply with the 409A NSO and SAR Exceptions. The terms of the SARs at all times provide that the awards are settled in service recipient stock. The service provider has the same redemption rights with respect to common shares acquired in connection with the exercise of the awards as other common shareholders of the service recipient.

In the Ruling, the IRS provides that the statutory definition of nonqualified deferred compensation for purposes of section 457A is substantially the same as the language in the 409A SAR Exception. The IRS relied on language in the legislative history of TEAMTRA that provided that, for purposes of section 457A, it is not intended that the term nonqualified deferred compensation includes amounts taxed under section 83. The IRS determined that although SARs are subject to section 457A, a stock-settled SAR is functionally identical in all material respects to NSOs with a net settle feature, and the stock transfer under a net-settled SAR, like the transfer of stock upon the exercise of a NSO, is taxable under section 83.

Based on the language in the statute and legislative history for section 457A, the IRS determined that NSOs that satisfy the requirements of the 409A NSO exception and SARs that at all times must be settled, and are settled, in service recipient stock and satisfy the requirements of the 409A SAR exception are not subject to section 457A. SARs that are settled in stock that is not service recipient stock are not exempt from section 457A, regardless of whether the SAR is nonqualified deferred compensation for purposes of section 409A. The holding in the Ruling is consistent with the guidance that was provided in Notice 2009-8 and provides that the guidance applies to NSOs and stock-settled SARs granted by a nonqualified entity to a non-individual service recipient.

Generally, section 457A prevents deferral of taxation of nonqualified deferred compensation sponsored by a nonqualified entity beyond the year in which the amounts vest. With the release of the Ruling, there have been discussions in the hedge fund industry that interprets the Ruling as clarifying that hedge funds can charge incentive fees cumulatively rather than annually without triggering taxation under section 457A. It appears that the Ruling is intended to provide assurance that NSOs that satisfy the 409A NSO exception and stock-settled SARs that satisfy the 409A SAR exception are not subject to section 457A. As a result,

it is not clear that the holding in the Ruling may be interpreted to support an exemption from section 457A for other fee arrangements.

Under the terms of the NSOs and SARs discussed in the Ruling, the service provider enjoyed any appreciation in the service recipient stock while such rights were held, and the service provider was taxable upon exercise in an amount equal to the difference between the fair market value on the date of exercise and the exercise price. Such income is taxable as ordinary income. By controlling the exercise date, service provider in effect was able to achieve an element of deferral, but at the same time its entire compensation was at risk as a result of being tied to the value of the service recipient stock. Therefore, stock-settled NSOs and SARs are not economically equivalent to pre-2009 nonqualified deferred compensation plans that many hedge fund managers utilized, but going forward may represent a viable alternative to achieve deferral.

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