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June 19, 2014

Stock Rights Under §457A: Revenue Ruling 2014-18

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Since 2008, the Internal Revenue Code (Code) has generally required that a service provider with a right to deferred compensation under a nonqualified deferred compensation plan of a "nonqualified entity" include the deferred amount in income as soon as there is no "substantial risk of forfeiture" of the right to compensation, even though the compensation is not payable currently and the obligation to pay is unfunded and unsecured. This rule, found in Code section 457A, is even more onerous than that of an analogous provision, section 409A, that also applies to nonqualified deferred compensation arrangements. If the section 457A rule applies, a service provider with rights to deferred compensation must take amounts into income under timing rules similar to those generally applicable to accrual method taxpayers,[1] thereby making deferred compensation arrangements within the scope of section 457A disadvantageous.

A "nonqualified entity" is generally (i) a foreign corporation, unless all or substantially all of its income is either effectively connected with the conduct of a trade or business in the U.S. or subject to a "comprehensive foreign income tax," or (ii) a partnership, unless substantially all of its income is allocable to persons other than (A) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax and (B) organizations exempt from tax under the Code.

Thus, situations to which section 457A may be applicable include (by way of illustration) deferred compensation arrangements for U.S. persons who provide services to (i) an offshore fund based in a jurisdiction that is not considered to have a comprehensive income tax, or (ii) any partnership a substantial portion of the income of which is allocated to pension funds, governmental entities, or other persons exempt from income tax.

In general, a right to compensation is treated as subject to a substantial risk of forfeiture for this purpose only if the right to compensation is conditioned on the performance of substantial services. The existence of a financial target or other goal that must be achieved before a payment becomes due is not a substantial risk of forfeiture. A stock right is not subject to a substantial risk of forfeiture if it is currently exercisable for cash or substantially vested property.[2]

IRS Notice 2009-8 (the Notice) provided initial guidance regarding section 457A, including the application of that provision to stock options (options) and stock appreciation rights (SARs) with respect to stock of a service recipient (collectively, stock rights).

Stock rights within the scope of a safe harbor established by regulations under section 409A are not treated as deferrals of compensation subject to section 409A. Under the Notice, such stock rights are generally excluded from the onerous timing rules of section 457A as well.

There is one noteworthy exception. Section 457A(d)(3)(A) provides that the term "nonqualified deferred compensation plan" generally has the meaning given that term under section 409A, *except that* "such term shall include 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."

Taking into account the above-quoted language (and discussion in committee reports relating to the enactment of section 457A),[3] it seemed clear that at least *some* SARs that would *not* be deferrals of compensation for purposes of section 409A *were* nonetheless intended to be subject to section 457A. The rationale for this distinction is not clear from the committee reports, but may be related to concerns that section 457A was intended to limit or preclude the payment of certain deferred services income computed by reference to the value or profits of the service recipient.[4]

Economically, it is difficult to identify a meaningful difference between an option and a SAR with respect to the same underlying shares. Even the mechanical distinction between an option, which requires the option holder to pay an exercise price upon exercise, versus a SAR that does not impose such a re-

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quirement (and simply requires a payment to be made upon exercise equal to the difference between the then value of the underlying shares and a reference price), is eliminated if an option includes a common "net exercise" feature, under which the optionee may be permitted to receive, in the form of stock, only the "spread" between the value of the underlying shares and the exercise price, in lieu of tendering the exercise price.

While the Notice does not contain any analysis along these lines, it does provide that a SAR otherwise within the scope of the section 409A safe harbor will not be a deferral of compensation subject to section 457A if the SAR provides by its terms that it must be settled in the form of shares of stock of the service recipient, and it is, in fact, settled in the form of shares of stock.[5]

Rev. Rul. 2014-18

Revenue Ruling 2014-18[6] amplifies the brief discussion in the Notice in respect of options and stock-settled SARs. The facts set forth in the ruling are that a foreign corporation that is a nonqualified entity (Service Recipient) receives services from a U.S. limited liability company classified as a partnership for tax purposes (Service Provider), the income of which is allocated to persons subject to U.S. income tax. Service Recipient and Service Provider are not at any time treated as a "single employer" under relevant standards.[7]

Service Recipient grants to Service Provider, as incentive compensation, an option and a SAR, each with respect to a fixed number of common shares of Service Recipient. (It is unclear whether these are "tandem" stock rights under which, if the SAR were exercised as to all or some of the underlying shares, the option would lapse as to the same quantity of shares.) The stock rights are granted at an exercise price or reference price not less than the fair market value of the underlying shares on the date of grant, and otherwise meet the requirements of the section 409A safe harbor. Further, the SAR provides that it must be settled in Service Recipient stock and is ultimately settled in such stock.

The ruling further provides that Service Provider has the same redemption rights with respect to shares acquired upon exercise of the stock rights as other shareholders have with respect to their common shares of Service Recipient stock—an interesting observation given that, outside the context of investment funds and some closely held companies, common shareholders most often have no redemption rights.

The ruling discusses relevant provisions of sections 409A and 457A, regulations under section 409A, and legislative history relating to the treatment of SARs under section 457A. It notes the exclusion from both sections 409A and 457A (by regulations under section 409A and under the Notice) of arrangements taxable under section 83, relating to the transfer of property in connection with the performance of services (including options that are within the scope of the safe harbor established by regulations under section 409A); and notes that a stock-settled SAR is "functionally identical" to an option with a net exercise feature. It further observes that a transfer of stock under a stock-settled SAR, like a stock transfer upon exercise of an option, is taxable under section 83.

Accordingly, the ruling concludes, an option that is exempt from section 409A, and a SAR that is required to be settled in stock and ultimately settled in stock, are also exempt from section 457A.

Observations

Rev. Rul. 2014-18 does not appear to reflect any major change in IRS thinking with respect to the treatment of options and SARs under section 457A as previously expressed in the Notice.

The ruling may provide to prospective issuers and recipients of stock-settled SARs some greater degree of comfort that those SARs will not be subject to section 457A. Further, the reference in the ruling to redemption rights indicates that the fact that the stock-settled SAR is satisfied with shares that are redeemable, and that are ultimately redeemed for cash or other property, will not cause the SAR to be viewed as something other than a stock-settled SAR for these purposes.

Conversely, the description of facts in the ruling to the effect that Service Recipient grants both an option and a SAR to Service Provider may make it desirable to grant options and SARs in tandem in situations where there is a concern as to the potential applicability of section 457A.

In addition, holders of SARs that may be settled through the payment of cash, or other property other than service recipient stock, remain exposed to adverse tax treatment under section 457A.

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1 In some respects, the section 457A rules are even harsher than those of the accrual method generally, as an interest charge and penalty tax equal to 20% of the compensation must be paid if income inclusion is postponed because the amount is not determinable at the time otherwise required to be taken into income under this provision. IRC § 457A(c). By contrast, the accrual method generally does not apply to items that are not yet determinable.

2 *See* IRS Notice 2009-8, 2009-4 IRB 347, A-3.

3 *See, e.g.*, Joint Committee on Taxation, *Technical Explanation of H.R. 7060, the Renewable Energy and Job Creation Tax Act of 2008* (JCX-75-08), at 147 ("[S]tock appreciation rights (SARs) are treated as nonqualified deferred compensation under the provision, regardless of the exercise price of the SAR.").

4 In contexts to which section 457A is applicable, such deferral is generally adverse to the fisc because the service recipient is tax-indifferent and the service provider's tax liability is deferred. By contrast, in the most typical contexts to which section 409A (but not sec-

tion 457A) is applicable, the net fiscal impact of the deferral may be minimal because the service recipient is generally subject to U.S. tax and its deduction for compensation expense is delayed until the year in which the compensation is paid.

[5] Notice 2009-8, A-2(b). The consequences if a SAR is written to provide for settlement in shares, but is then ultimately settled for other consideration, are not specified in the Notice. The same paragraph further provides that with respect to a right to purchase an equity interest in a non-corporate entity, the stock right safe harbor rules may be applied by analogy.

[6] 2014-26 IRB __.

[7] IRC sections 414(b) and (c) treat certain entities with more than 50% (in some circumstances, 80% or more) commonality of ownership as a single employer. *See also* Reg. § 1.409A-1(b)(5)(iii)(E)(3), concerning the effective exclusion from the section 409A safe harbor for stock rights, of certain corporate structures established in order to provide deferred compensation not subject to the application of section 409A.