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A Case For Hedging Your Bets With Deferred Compensation

Law360, New York (June 13, 2014, 12:38 PM ET) -- Under Section 457A of the Internal Revenue Code of 1986, certain offshore and other entities are limited in their ability to provide tax-effective deferred compensation to providers of services to those entities. In Revenue Ruling 2014-18 issued recently, the Internal Revenue Service confirmed that certain equity-based compensation arrangements are not subject to Section 457A. The ruling could lead to increased interest on the part of investment funds and their sponsors to explore the use of certain types of equity-based compensation arrangements.

Background

Historically, managers of various investment funds were sometimes compensated on a tax-deferred basis. Some funds had deferred compensation programs under which deferrals were effectively reinvested in fund interests until the compensation was paid.

In 2008, Congress enacted Section 457A of the Internal Revenue Code to curb the use of deferred compensation arrangements and tax deferral by certain offshore and other entities not subject to a comprehensive tax regime. Based on its legislative history, Section 457A of the code is intended to promote parity among taxpayers.

U.S.-taxable entities that grant nonqualified deferred compensation to their service providers are unable to receive a tax deduction for the deferred compensation until the amount is paid to the employee or other service provider. Thus, when a service provider defers compensation, the service provider defers tax on the compensation at the cost of the service recipient's deferral of the corresponding tax deduction.

The resulting tension between the service provider and the service recipient may tend to make an employer or other service provider less willing to agree to a deferral of the service provider's compensation. Conversely, if the service recipient is not subject to a comprehensive tax regime, this natural tension is not present — while the employee or other service provider would benefit from potential tax deferral, the timing of tax deductions is irrelevant for the employer or other service recipient because the service recipient is not subject to tax at all.

Section 457A of the Internal Revenue Code and Its Effect on the Market

In an effort to level the playing field between taxable and nontaxable recipients of services, Congress passed Section 457A of the code, which, in general terms, effectively eliminates the ability of U.S. service providers to defer taxation on compensation paid by certain tax-indifferent parties. Many investment funds are subject to Section 457A and, as a result, their efforts to defer compensation need to be structured to avoid Section 457A.

A number of approaches have developed in the market to accomplish the payment of compensation where tax deferral is sought. Some approaches involve the use of partnership interests, which generally are not subject to Section 457A.

Certain other approaches involve the use of compensation that is subject to vesting requirements, with the intention that the compensation not be considered "deferred" for Section 457A purposes.[1] Ultimately, though, Section 457A has, in a variety of cases, had a chilling effect on the provision by investment funds of deferred compensation to their managers.

Revenue Ruling 2014-18

After the enactment of Section 457A of the code, the IRS clarified that certain equity-based compensation was not subject to Section 457A. In Notice 2009-082, the IRS indicated that certain types of stock options and stock appreciation rights (SARs) settled in stock are not subject to Section 457A.[3]

In general terms, (1) a stock option is the right to buy a specified number of shares of stock of the employer or other service recipient at a fixed price during a stated time period, and (2) an SAR is a right to compensation based on the appreciation in value over a limited time of a specified number of shares of stock of the employer or other service recipient.[4]

After the notice, there arguably continued to be a general reluctance on the part of investment funds and their sponsors to adopt option or SAR arrangements intended to avoid the reach of Section 457A of the code. It appears that, in light of the substantial adverse tax consequences under Section 457A, some in the market were unwilling to proceed absent further clarification.

With its issuance of the ruling, the IRS has generally confirmed that options and stock-settled SARs are indeed not subject to the restrictions of Section 457A of the code. In addition, the notice provides that, for purposes of determining whether Section 457A applies to "an equity interest in a noncorporate entity (meaning a right to purchase actual equity in such entity, and not a mere right to an amount equal to the appreciation in such equity)," the otherwise applicable rules "are applied by analogy."[5]

In light of the foregoing, it would appear that the clarification provided by the IRS in the ruling may be relevant to corporate and noncorporate entities alike, and therefore relevant with respect to a wide range of investment funds. As a practical matter, the stock-settled SAR structure, as compared with the option structure, may be of more relevance in the funds context.

Next Steps

While SARs and similar noncorporate interests are not necessarily appropriate for all funds as a business matter, there may be funds for which such interests indeed accomplish the compensation-related goals of the fund, its sponsor and the manager (and may also be desirable from the perspective of investors).

For those funds, it now may be possible, with a greater level of comfort, to structure a tax-efficient program that permits a manager to defer its compensation (and, in the case of an entity manager, that permits the principals of the entity in turn to defer their compensation). In addition, there may be a wide range of vesting and other ancillary features that can be incorporated into the SAR arrangement, thereby potentially further increasing the utility of the arrangement from a design perspective.

Funds and their sponsors that are interested in tax-effective deferred compensation may want to review the ruling to see if an SAR or SAR-type compensation plan may present a workable solution that avoids the restrictions of Section 457A.

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[1] Under Section 457A(d)(3)(B) of the code, compensation is generally not considered “deferred” if it is paid no later than 12 months after the end of the service recipient’s taxable year during which the compensation vests.

[2] 2009-4 I.R.B. 347.

[3] Regarding SARs, Q&A 2(b) of Section B of the notice states, in relevant part, that “the exception from coverage under [applicable principles] may be applied so that [an SAR] which by its terms at all times must be settled in service recipient stock, and is settled in service recipient stock (and otherwise meets the [applicable requirements]), will be excluded from coverage under § 457A.”

[4] One way to look at an SAR is that the SAR is the economic equivalent of an option, where on exercise the option’s exercise price is netted out of the proceeds of the exercise of the option.

[5] See also Preamble, Application of Section 209A to Nonqualified Deferred Compensation Plans (Final Regulations), 72 Fed. Reg. 19,234, 19,243, § III.G (Apr. 17, 2007), corrected, 72 Fed. Reg. 38,477 (July 13, 2007), 72 Fed. Reg. 41,620 (July 31, 2007), modified in part, Notice 2007-86, 2007-2 C.B. 990.