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An Appreciation for Fund-Based Deferred Compensation

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Under Section 457A of the Internal Revenue Codeof 1986, as amended (the ''Code''), certain offshore and other entities are limited in their ability to provide tax-effective deferred compensation to providers of services to those entities. Last week, on June 10, in Revenue Ruling 2014-18 (the ''Ruling''), 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.

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I. Background

In 2008, Congress added Section 457A to the Code to curb the use of deferred compensation arrangements by certain offshore and other entities not subject to a comprehensive tax regime.[1] Initially, the proposals that eventually became Section 457A were informed by the perception that U.S.-based managers of offshore hedge funds had a substantially greater opportunity than other taxpayers to benefit from arrangements providing for tax-deferred compensation.[2]

As ultimately enacted, Section 457A was intended more generically to address situations in which an employer or other service recipient is indifferent as to when it deducts compensation paid to its service providers in situations in which the service recipient is not subject to a comprehensive taxation system. 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 taxation 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 re-

[1] Section 457A was added by the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343.

[2] See Press Release, Sen. John F. Kerry, Doc 2007-23346, 2007 TNT 203-26 (Oct. 18, 2007); Press Release, Rep. Rahm Emanuel, Doc 2007-23293, 2007 TNT 202-23 (Oct. 17, 2007).

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cipient may tend to make an employer or other service recipient 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.[3]

In an effort to level the playing field between taxable and nontaxable recipients of services, Congress passed Section 457A of the Code. While previous efforts by Congress in Section 457 (applicable to deferred compensation plans of state and local governments and other tax-exempt organizations) to address the lack of tax-based tension between a service provider and a nontaxable service recipient involved limiting deferred compensation,[4] Section 457A effectively eliminates the ability of U.S. service providers to defer taxation on compensation paid by certain tax-indifferent service recipients.

Section 457A generally seeks to achieve its goals by accelerating inclusion in taxable income of deferred amounts to the year in which such amounts are no longer subject to a substantial risk of forfeiture, or in certain circumstances, by imposing penalty taxes.[5] Unlike in the case of Section 409A (applicable generally with respect to nonqualified deferred compensation), it is not that deferrals need to be structured in a compliant manner with respect to Section 457A, but, rather, that, if Section 457A applies, tax-deferral of compensation is essentially not permitted at all. Given its inflexibility, combined with its breadth and complexity,[6] Section 457A can be a daunting provision for those entities that are subject to it.

Historically, prior to the enactment of Section 457A, managers of various investment funds had been permitted to receive all or a portion of their compensation on a tax-deferred basis, often with the deferred amounts being effectively reinvested in the fund. Many investment funds are now subject to Section 457A and, as a result, efforts to defer fund-related compensation may need to be structured to avoid Section 457A.

II. Section 457A and Its Application to Certain Equity-Based Compensation

Section 457A requires that amounts deferred under a ''nonqualified deferred compensation plan'' of a ''nonqualified entity'' be included in the gross income of the service provider in the year in which such amounts are no longer subject to a substantial risk of forfeiture,[7] even if not then received by the service provider.[8] To the extent that such an amount is not determinable at the time that there is no substantial risk of forfeiture, inclusion (and therefore, taxation) is deferred until the amount is determinable,[9] but the amount eventually included in income is subject to an additional 20 percent tax plus an additional interest charge.[10]

As a fundamental matter, ''nonqualified deferred compensation plan'' is defined for these purposes by cross reference to Section 409A(d). Generally, a ''nonqualified deferred compensation plan'' for purposes of Section 409A is a plan that provides for compensation that will be paid to a service provider in a year subsequent to the year in which the service provider has a legally binding right to such compensation.[11]

However, the reaches of Section 409A and Section 457A are not coextensive to the extent that the applicable statutory provisions are not identical. As relevant here, Section 457A(d)(3)(A), unlike Section 409A, expressly includes in the definition of a ''nonqualified deferred compensation plan'' ''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.'' In contrast, stock rights, including stock options and stock appreciation rights (''SARs'') that meet certain requirements,[12] are broadly excluded from the reach of Section 409A.[13]

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[3] See generally H.R. Rep. No. 110-658, at 194-95 (2008) (''Conference Report''); Staff of Joint Comm. on Tax'n, General Explanation of Tax Legislation Enacted in the 110th Congress (JCS-1-09) 528 (2009) (''Blue Book'').

[4] See generally Conference Report, at 194-95; Blue Book, at 527-28.

[5] See § 457A(a), (c).

[6] See generally New York State Bar Association Tax Section, Report 1193, ''Report on Rules Governing Nonqualified Deferred Compensation Under Section 457A'' (Oct. 5, 2009) (191 PBD, 10/6/09; 36 BPR 2331, 10/13/09).

[7] Under Section 457A, an amount is subject to substantial risk of forfeiture only if the service provider's right to the amount is conditioned on the future performance of substantial services. § 457A(d)(1)(A).

[8] § 457A(a).

[9] § 457A(c)(1)(A).

[10] § 457A(c)(1)(B).

[11] § 409A(d); Treas. Reg. § 1.409A-1(b)(1).

[12] Treas. Reg. § 1.409A-1(b)(5).

[13] There are other contrasts between the manner in which 409A applies and the manner in which Section 457A applies. For example, the exclusion for short-term deferrals under Section 457A is broader than the corresponding exclusion from Section 409A, both as to length of time (the one-year provision in Section 457A(d)(3)(B) is longer than the period set forth in Section 1.409A-1(b)(4) of the Treasury Regulations) and arguably as to structure (the Section 457A short-term deferral is framed in terms of when payment is made, whereas the regulatory short-term deferral provisions applicable for Section 409A purposes have a substantial form-based component). In this regard, it is noted that one of the authors had argued that the effort in Q&A 2(c) of Notice 2009-8 to expand the reach of Section 457A to arrangements that are short-term deferrals for purposes of Section 409A, and that therefor are not nonqualified deferred compensation plans subject to Section 409A, was invalid, in the absence of a textual basis for applying Section 457A to arrangements that were not plans covered by Section 409A. See Oringer, ''Deferred Comp. 'Plan': In the Cross Hairs of a Cross-Reference,'' 123 Tax Notes 93 (2009). Section 457A was later proposed to be amended by a technical correction that would add a new Section 457A(d)(3)(A)(ii) to the Code in

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After the enactment of Section 457A, the IRS attempted to clarify that Section 457A(d)(3)(A) does not result in coverage by Section 457A of certain types of equity-based compensation. Specifically, in Notice 2009-08[14] (the ''Notice''), the IRS indicated that certain types of stock options and SARs settled in stock are not subject to Section 457A. In general terms, (i) 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,[15] and (ii) 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.[16] One possible way to look at an SAR could be 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.[17]

Regarding options, Q&A 2(b) of the Notice generally provides that the Section 409A exclusions therefor apply for purposes of Section 457A.[18] As a practical matter, however, in the context of fund-related compensation, SARs, rather than options, may be the more relevant type of compensatory interest.

Regarding SARs, Q&A 2(b) of the Notice states, in light of Section 457A(d)(3)(A)'s inclusion within the scope of ''nonqualified deferred compensation plan'' of a plan involving equity appreciation, as noted above, that the blanket exclusion of SARs from the scope of Section 409A does not apply for purposes of Section 457A.[19] However, the IRS went on to provide that SARs settled in stock (as opposed to cash), if otherwise described by the Section 409A regulations, are excluded from the reach of Section 457A, stating as follows: ''[T]he exception from coverage under § 1.409A-1(b)(5)(i)(B) may be applied so that a stock appreciation right 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 requirements of that section), will be excluded from coverage under § 457A.''[20]

The Notice also addresses the application of these concepts in the non-corporate context, stating that, for purposes of determining whether Section 457A applies to ''an equity interest in a non-corporate 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.''[21]

III. Revenue Ruling 2014-18

Following the enactment of Section 457A, a number of approaches have developed in the market to accomplish the payment of tax-deferred compensation to certain fund managers. Some approaches have involved the use of partnership interests, which generally are not subject to Section 457A.[22] 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.[23] As a practical matter, however, Section 457A has, in a variety of cases, dramatically curtailed the ability of fund managers of offshore funds to defer compensation for tax purposes.

One possible approach that has been suggested in the funds context to addressing the restrictions of Section 457A has been the provision of stock-settled SARs of the service recipient, in reliance on the Notice.[24] However, 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. 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. Now,

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order to address this issue. See, e.g., Tax Technical Corrections Act of 2009, § 4(c)(3)(A); see also Staff of Joint Comm. on Tax'n, Description of the Tax Technical Corrections Act of 2009 (JCX-56-09) (2009) (''The bill clarifies that the rules of section 457A defining substantial risk of forfeiture, not the rules defining it in section 409A, apply for purposes of section 457A.''). This technical correction has not yet been passed by Congress.

[14] 2009-4 I.R.B. 347.

[15] Treas. Reg. § 1.409A-1(b)(5)(i)(A).

[16] Treas. Reg. § 1.409A-1(b)(5)(i)(B).

[17] See also Ruling (''Although stock appreciation rights are generally subject to section 457A, a stock appreciation right that at all times by its terms must be settled, and is settled, in service recipient stock is functionally identical in all material respects to a nonstatutory stock option to purchase service recipient stock with a net exercise feature . . . .''); infra note 26 and accompanying text.

[18] Notice, Q&A 2(b) (third sentence).

[19] Notice, Q&A 2(b) (first two sentences).

[20] Notice, Q&A 2(b) (fourth sentence).

[21] Notice, Q&A 2(b) (last sentence); see also Preamble, Application of Section 409A 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 (the ''Final Section 409A Preamble'') (expressly preserving the relief in Q&A 7 of Notice 2005-1, 2005-1 C.B. 274, to the effect ''that until further guidance is issued for purposes of section 409A, taxpayers may treat the issuance of a partnership interest (including a profits interest) . . . , granted in connection with the performance of services[,] under the same principles that govern the issuance of stock''); Preamble, Application of Section 409A to Nonqualified Deferred Compensation Plans (notice of proposed rulemaking and notice of public hearing), 70 Fed. Reg. 57,930, 57,937, § II.E. (Oct. 4, 2005), *corrected*, 70 Fed. Reg. 75,090 (Dec. 19, 2005) (also expressly preserved by the Final Section 409A Preamble).

[22] See Notice, Q&A 2(a) (''[w]ith respect to an arrangement between a partner and a partnership, taxpayers may rely upon the applicable guidance under § 409A''); Final Section 409A Preamble, § III.G. (''Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7 and sections II.E. and VI.E. of the preamble to the proposed regulations.''); Notice 2005-1, 2005-1 C.B. 274, Q&A 7 (''[U]ntil additional guidance is issued, for purposes of section 409A, taxpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated under applicable guidance as not resulting in inclusion of income by the service provider at the time of issuance, as also not resulting in the deferral of compensation. Similarly, until additional guidance is issued, for purposes of section 409A, taxpayers may treat an issuance of a capital interest in connection with the performance of services in the same manner as an issuance of stock.'').

[23] Under Section 457A(d)(3)(B), 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. See also supra note 13.

[24] See, e.g., Earle, ''Compensating Hedge Fund Managers with Stock Options: A New Path to Alignment of Interests with Investors,'' 23 Bens. L.J. 80, 89 (2010).

with the issuance of the Ruling, the IRS has confirmed that certain stock options and stock-settled SARs are indeed not subject to the restrictions of Section 457A.

In the Ruling, the IRS presented the analysis under which certain stock options and SARs are not covered by Section 409A. The IRS then stated that a stock right meeting the applicable requirements under Section 409A ''is therefore also exempt from section 457A, unless it constitutes, as set forth under section 457A(d)(3)(A), 'a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient.' ''

The IRS proceeded to quote from Section 457A's legislative history, as follows:

> Under the provision, nonqualified deferred compensation includes any arrangement under which compensation is based on the increase in value of a specified number of equity units of the service recipient. Thus, stock appreciation rights (SARs) are treated as nonqualified deferred compensation under the provision, regardless of the exercise price of the SAR. It is not intended that the term nonqualified deferred compensation plan include an arrangement taxable under section 83 providing for the grant of an option on employer stock with an exercise price that is not less than the fair market value of the underlying stock on the date of grant if such arrangement does not include a deferral feature other than the feature that the option holder has the right to exercise the option in the future.[25]

Based on the foregoing, the IRS stated:

> Although stock appreciation rights are generally subject to section 457A, a stock appreciation right that at all times by its terms must be settled, and is settled, in service recipient stock is functionally identical in all material respects to a nonstatutory stock option to purchase service recipient stock with a net exercise feature . . . .
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> Accordingly, a nonstatutory stock option exempt from section 409A is exempt from section 457A. In addition, a stock appreciation right exempt from section 409A that at all times by its terms must be settled, and is settled, in service recipient stock is exempt from section 457A. . . .[26]
>
> Applying these principles, neither stock right with respect to common shares of Service Recipient granted to Service Provider is a nonqualified deferred compensation plan for purposes of section 457A(a) because each is either a nonstatutory stock option that meets the requirements of § 1.409A-1(b)(5)(i)(A) or a stock appreciation right that meets the requirements of § 1.409A-1(b)(5)(i)(B) and at all times by its terms must be settled, and is settled, in service recipient stock. The stock rights granted to Service Provider are accordingly exempt from section 457A.

With respect to funds organized as non-corporate entities, the foregoing could be read in conjunction with the provisions of the Notice referred to above that refer to applying principles like these ''by analogy'' to equity appreciation rights (''EARs'')[27] settled in nonstock equity interests in non-corporate entities.[28] In light of the Notice, it would appear that the clarification provided by the IRS in the Ruling may be relevant to corporate and non-corporate entities alike, and therefore potentially relevant with respect to a wide range of investment funds.

A number of general interpretive issues regarding the Ruling may remain, including:

- There could be questions in the case of redemptions or transfers immediately or shortly after distribution, and whether an SAR or EAR would be respected as stock-settled or settled in non-corporate equity, respectively, in such a case. In this regard, however, it is not immediately obvious that an equity-settled interest should be recharacterized as cash-settled, even if there is an immediate redemption or transfer. The IRS did address redemptions in the Ruling, but in this regard only recited as a fact of the Ruling that ''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 Service Recipient.'' The IRS had the opportunity to include in the Ruling a condition regarding the timing of post-transfer redemptions or transfers (or otherwise to indicate that an interest might not be respected as stock-settled in the case of a near-term redemption or transfer), but did not do so.

- The passive foreign investment company (''PFIC'') rules of Sections 1291 through 1297, and other relevant international/cross-border tax issues, should be reviewed regarding their possible application in the context of any particular EAR program.

- The precise manner in which the Ruling (and the Notice) may apply in the non-corporate context may be subject to some continuing uncertainty.

- There could also be a range of additional issues that might arise given the details of any particular proposed arrangement.

IV. Certain Possible Ways Forward

As noted above, notwithstanding the issuance of the Notice, there may have been some reluctance on the part of investment funds and their sponsors to adopt SAR or other EAR arrangements intended to avoid the reach of Section 457A, absent further clarification. The Ruling may well provide the desired clarification, and fund and fund sponsors that were previously unwilling to consider stock-settled SAR or other equity-settled EAR arrangements may find it worthwhile to reexamine the issue. The Ruling may cause funds and their sponsors that are interested in tax-effective deferred compensation to see if an SAR or SAR-type compensation plan may present a workable solution that avoids the restrictions of Section 457A.

A natural preliminary step in the inquiry would seem to be to ascertain whether an EAR program would make sense with respect to any given fund as a business matter. While SARs and similar non-corporate 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. It should also be noted that fund investors, as well as funds, fund sponsors and their managers, may view SAR/EAR arrangements favorably, and, at least in one case, a pension investor appears to have affirmatively advocated for confirmation that compensation in the nature of

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[25] Conference Report, at 195; see also Blue Book, at 529.

[26] The IRS also expressly stated the contrary proposition that ''[a] stock appreciation right that may be or is settled other than in service recipient stock is not exempt from section 457A, regardless of whether the stock appreciation right is a nonqualified deferred compensation plan for purposes of section 409A.''

[27] Dare we suggest saying, ''We are all EARs''?

[28] See supra note 21 and accompanying text.

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stock options can avoid the application of Section 457A.[29]

If stock-settled SARs or other equity-settled EARs make sense from a non-tax business perspective, 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. The following features are among those that funds and their managers may wish to consider:

- In the case of an entity manager organized as a partnership for tax purposes, income from the exercise of SARs/EARs may be able to be allocated to the entity's principals under their partnership (for tax purposes) interests. As indicated above, under present law such allocations should, if ultimately paid out as bona fide partnership distributions,[30] generally avoid the application of both Sections 457A and 409A.[31]

- There may be a wide range of vesting and other ancillary features that can be incorporated into the SAR/EAR arrangement, thereby potentially further increasing the utility of the arrangement from a design perspective. If the SARs or other EARs successfully avoid the application of Section 457A (and Section 409A), the breadth of the possible design features that can overlay the basic SAR/EAR structure could be substantial, constrained almost exclusively by non-tax business considerations.

- It may be possible to cap upside returns, if there is a concern that the SAR/EAR could provide payments considered excessive as a business matter.[32]

- It may be possible to flow the economics of the underlying SARs/EARs to employees of an entity manager, using a plan involving short-term deferrals for Section 457A and Section 409A purposes (i.e., using a plan that does not provide ''deferred compensation'' for such purposes).

Conclusion

Since the enactment of Section 457A, various funds and their sponsors, and fund managers, that have been interested in providing or receiving tax-deferred compensation have been exploring possible approaches structured with the intent of avoiding the reach of Section 457A. Despite some favorable indications in the Notice, there has arguably been reluctance in the market regarding the use of SAR- and EAR-based programs.

Now, with the additional clarification provided by the Ruling, there may be increased consideration in the funds market of SAR and other EAR arrangements. For funds for which such arrangements make sense as a non-tax business matter, SARs and EARs could provide a tax-efficient way to defer compensation to their managers. In addition, there may be a wide range of vesting and other ancillary features that can be incorporated into the compensation arrangement, thereby potentially further increasing the utility of this type of arrangement from a design perspective. If the Ruling is received positively by the market, SARs and EARs may well become a key part of the compensation toolkit for funds and fund managers, for the foreseeable future.

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[29] A Sept. 10, 2010, letter that appears to have been written by a public pension system to Sen. Orrin G. Hatch advocates for the increased use of ''stock option-based compensation,'' asserting, on a number of bases, that ''[t]his compensation technique can result in better returns to investors.'' See also Press Release, ''CalPERS Moves to Restructure Hedge Fund Relationships—Seeks Better Model for Alignment, Control, Fees and Transparency'' (Mar. 27, 2009) (''Performance fees should be based on long-term performance, and mechanisms such as delayed realizations and clawbacks can better align long-term interests of managers and investors.'').

[30] It is assumed that the distributions would not constitute ''guaranteed payments'' for purposes of Section 707(c). See Final Section 409A Preamble, § III.G. (providing that guaranteed payments that would otherwise constitute a deferral of compensation would ordinarily be subject to Section 409A); Notice 2005-1, Q&A 7 (stating that ''section 409A may apply to payments covered by § 707(a)(1) (partner not acting in capacity as partner), if such payments otherwise would constitute a deferral of compensation under a nonqualified deferred compensation plan''); Notice, Q&A 2(a) (''With respect to an arrangement between a partner and a partnership, taxpayers may rely upon the applicable guidance under § 409A.'').

[31] See supra note 22 and accompanying text.

[32] Cf. Treas. Reg. § 1.409A-1(b)(5)(iii)(A) (stating that the stock delivered under a stock option cannot be required to be repurchased for more than its fair market value); Treas. Reg. § 1.409A-1(b)(5)(i)(B)(1) (stating that compensation cannot be ''greater than'' the applicable spread).