

Section 457A.—Nonqualified Deferred Compensation from Certain Tax Indifferent Parties

(Also: Section 409A; 1.409A-1: Stock Rights)

Rev. Rul. 2014-18

ISSUE

Whether a nonstatutory stock option or a stock-settled stock appreciation right with respect to common stock of a nonqualified entity is a nonqualified deferred compensation plan subject to taxation under section 457A of the Internal Revenue Code (Code).

FACTS

Service Recipient is a foreign corporation and a nonqualified entity for purposes of section 457A(b). Service Provider is a limited liability company organized under state law and treated as a partnership for U.S. income tax purposes. Income of Service Provider is allocated to persons subject to U.S. income tax. Service Provider provides services to Service Recipient. Service Recipient and Service Provider are not at any time treated as a single employer under section 414(b) or (c).

As incentive compensation for Service Provider, Service Recipient grants a nonstatutory stock option and a stock appreciation right (in each case, a stock right) to Service Provider, each with respect to a fixed number of common shares of Service Recipient, which qualify as service recipient stock (as defined under Treas. Reg. §1.409A-1(b)(5)(iii)). Each stock right has an exercise price per share that is not less than the fair market value of a common share of Service Recipient on the date of grant, determined pursuant to Treas. Reg. §1.409A-1(b)(5)(iv). The stock rights do not include any feature for the deferral of compensation (as defined under Treas. Reg. §1.409A-

1(b)(5)(i)(D)) and otherwise comply with the requirements of Treas. Reg. §1.409A-1(b)(5)(i)(A) or (B), as applicable. The terms of the stock appreciation right at all times provide that it must be settled in service recipient stock, and the stock appreciation right is settled in service recipient stock. 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.

LAW AND ANALYSIS

Section 457A(a) provides that any compensation that 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.

Section 457A(b) provides that the term “nonqualified entity” means (1) any foreign corporation unless substantially all of its income is (A) effectively connected with the conduct of a trade or business in the United States, or (B) subject to a comprehensive foreign income tax, and (2) any partnership unless substantially all of its income is allocated 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 which are exempt from tax under the Code.

Section 457A(d)(3)(A) provides that the term “nonqualified deferred compensation plan” has the meaning given such term under section 409A(d), “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.” Section 409A(d) provides that the term “nonqualified deferred compensation plan” means any plan that provides for the deferral of compensation other than certain enumerated exceptions.

Section 1.409A-1(b)(5)(i)(A) provides that a nonstatutory stock option to purchase a fixed number of shares of service recipient stock does not provide for the deferral of compensation for purposes of section 409A if the exercise price is not less than the fair market value of the underlying stock on the date the stock option is granted, the stock option does not include any feature for the deferral of compensation, and the other requirements of §1.409A-1(b)(5)(i)(A) are met. Section 1.409A-1(b)(5)(i)(B) provides that “a right to compensation based on the appreciation in value of a specified number of shares of service recipient stock occurring between the date of grant and the date of exercise of such right (a stock appreciation right)” does not provide for the deferral of compensation for purposes of section 409A if the exercise price is not less than the fair market value of the underlying stock on the date the right is granted, the right does not include any feature for the deferral of compensation, and the other requirements of §1.409A-1(b)(5)(i)(B) are met.

A stock right that meets the requirements of either §1.409A-1(b)(5)(i)(A) or (B) and is therefore exempt from 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." Section 457A was added to the Code by section 801(a) of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Pub. L. No. 110-343 (Div. C), 122 Stat. 3929 (2008) (TEAMTRA), more than one year after the issuance of final Treasury Regulations under section 409A. The language quoted above from section 457A(d)(3)(A) is substantially the same as the language set forth under §1.409A-1(b)(5)(i)(B) describing a stock appreciation right exempt from section 409A. The House Committee Report on TEAMTRA confirms that the quoted language is specifically intended to refer to a stock appreciation right and that a nonstatutory stock option that meets the requirements of §1.409A-1(b)(5)(i)(A) is intended to be exempt from section 457A:

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.

H.R. Rep. No. 110-658, at 195 (2008).

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, and the stock transfer under such an arrangement, like the stock transfer pursuant to the exercise of a nonstatutory stock option, is taxable under section 83.

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. 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.

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.

HOLDING

Neither the nonstatutory stock option nor the stock-settled stock appreciation right granted to Service Provider with respect to common shares of Service Recipient is a nonqualified deferred compensation plan subject to taxation under section 457A.

EFFECT ON OTHER REVENUE RULING(S)

Notice 2009-8, 2009-4 I.R.B. 347, Interim Guidance under Section 457A, is amplified.

DRAFTING INFORMATION

The principal author of this revenue ruling is Gregory Burns of the Office of Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue ruling, contact Gregory Burns at (202) 317-5600 (not a toll-free call).