



IRS Revenue Ruling Warmly Received by Hedge Funds and Expatriates

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The IRS recently released Revenue Ruling 2014-18 to clarify that stock options and stock appreciation rights (SARs) will not be considered nonqualified deferred compensation for purposes of Code Section 457A provided the awards are settled in stock and designed to satisfy Code Section 409A's "stock right" exemption.

Section 457A, which is separate from Section 409A, effectively eliminates the ability to defer compensation for taxpayers that provide services to "nonqualified entities." Nonqualified entities are typically foreign companies in tax-indifferent jurisdictions (colloquially, tax havens) or pass-through entities that are owned more than 20% by tax-exempt entities. Section 457A most commonly applies to hedge funds and expatriates working for a non-US employer in a tax-indifferent jurisdiction.

Since Section 457A became effective in 2009, some have been concerned that Section 457A and its potential 20% penalty tax would apply to any stock option or SAR granted to a service provider of a nonqualified entity. This concern arose from the explicit language of the statute, which defines nonqualified deferred compensation by referring to the definition in Section 409A(d), but then adds "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." The IRS previously tried to allay this concern in IRS Notice 2009-8, but now has used a more formal interpretation in Revenue Ruling 2014-18 to confirm that Section 457A does not apply to stock options and SARs that are stock-settled so long as they meet the stock right exemption in Code Section 409A. SARs that are or may be settled other than in service recipient stock (such as in cash) are not exempt from Section 457A.

This Ruling provides an interesting example of statutory interpretation. Despite the plain language of the statute, the IRS used the legislative history to find that 409A-exempt stock options were not intended to be subject to Section 457A. Further, the IRS stated that stock-settled SARs are functionally identical to stock options in all material respects and thus are similarly exempt. Perhaps constrained by the language of the statute, the IRS could not extend the exemption to SARs settled in cash.

On a related note, readers who are familiar with the proposed Code Section 409B in the Tax Reform Act of 2014 – which would effectively eliminate deferred compensation *and* stock options for all U.S. taxpayers – should note that the language in the proposed Section 409B is almost identical to the language in Section 457A, but with one important difference. Section 409B defines deferred compensation to 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 or *stock options*” (emphasis added), clearly trying to avoid any doubt about its intended reach.

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