

IRS issues guidance on application of section 457A to stock options and stock appreciation rights

IRC section 457A provides that amounts deferred under a nonqualified deferred compensation plan of a nonqualified entity are includible in gross income when they are no longer subject to a substantial risk of forfeiture. On June 10, the IRS issued Revenue Ruling 2014-18, confirming that certain stock rights with respect to a service recipient's common stock are not taxable under Section 457A. The ruling potentially offers certain offshore and other entities more flexibility in structuring tax-deferred compensation arrangements.

Background



Section 457A was enacted as part of the Emergency Economic Stabilization Act of 2008 to offset costs associated with the government's bailout of the US financial system. Originally aimed at eliminating income deferral by offshore hedge fund managers, section 457A also ended the deferral of compensation earned by US citizens (and green card holders) for services performed after 2008 for certain non-US corporations and partnerships.

Section 457A applies only to compensation of a US taxpayer deferred under a "nonqualified entity's" nonqualifying deferred compensation plan. For these purposes, a nonqualified entity is: (1) a foreign corporation, unless substantially all of its income is either effectively connected with a US trade or business or is subject to a comprehensive foreign income tax; or (2) a US or foreign partnership, unless substantially all of its income is allocated to persons whose income is subject to US tax or a comprehensive foreign income tax. Deferred compensation for purposes of section 457A generally has the same meaning as under section 409A. Unlike section 409A, however, section 457A includes "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 its definition of a nonqualified deferred compensation plan.

Except as noted below, deferred compensation provided by a foreign employer that provides a right to compensation based on stock appreciation rights (SARs) is subject to section 457A. In [Notice 2009-8](#), the IRS indicated that certain SARs and nonstatutory stock options (NSOs) on service recipient stock as well as incentive stock options are excluded from coverage under section 457A.

Revenue Ruling 2014-18

On June 10, the IRS issued [Revenue Ruling 2014-18](#), amplifying its prior guidance on the taxation of stock rights. The ruling addresses whether an NSO or a stock-settled SAR with respect to common stock of a nonqualified entity is a nonqualified deferred compensation plan subject to taxation under section 457A.

The scenario

In the scenario described in the revenue ruling, the service recipient is both a foreign corporation and a nonqualified entity subject to section 457A. The service provider is a limited liability company that is treated as a partnership for US tax purposes. As incentive compensation, the corporation grants stock rights to the service provider — an NSO and a stock-settled SAR — for a fixed number of common shares of the corporation's stock. Each stock right has a per share exercise price that is not less than its fair market value as of the grant date, and does not provide for the deferral of compensation. The SAR can be settled only in the corporation's stock, and the service provider has the same redemption rights for common shares acquired through exercising the stock rights as other common shareholders have.

The ruling

The revenue ruling confirms the exemption from section 457A for NSOs and stock-settled SARs. A stock right that is exempt from section 409A is also exempt from section 457A unless it constitutes "a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient."

While SARs are generally subject to section 457A, a SAR that must be — and is — settled in service recipient stock is like an NSO to purchase service recipient stock with a net exercise feature. Accordingly, an NSO exempt from section 409A is exempt under section 457A, and a SAR exempt from Section 409A that must be — and is — settled in service recipient stock is also exempt from section 457A. However, a SAR that may be — or is — settled other than in service recipient stock is not exempt from section 457A regardless of whether the SAR is a nonqualified deferred compensation plan under section 409A. Because each stock right described in the scenario above is either an NSO or a stock-settled SAR that is exempt under section 409A, neither is a nonqualified deferred compensation plan taxable under section 457A.

In closing

Section 457A involves significant compensation issues with broad implications. It imposes unfavorable tax treatment on taxpayers that defer compensation they receive from entities located in foreign tax havens. Revenue Ruling 2014-18 amplifies prior interim guidance on the application of section 457A to compensation that is deferred under a nonqualified deferred compensation plan. The ruling confirms that NSOs and SARs that provide for distribution and payment only in service recipient stock are exempt from section 457A.

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