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Client Alert
Commentary

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IRS Pursues 409A Audits, Issues Ruling on Certain Options/SARs under 457A

IRS audits signal focus on Section 409A compliance; Revenue Ruling makes certain nonqualified options and stock appreciation rights more attractive for offshore entities.

The IRS has begun its limited audit initiative of 50 large companies' nonqualified deferred compensation (NQDC) arrangements, which is intended to evaluate whether these arrangements comply with Internal Revenue Code Section 409A (Section 409A). In another development concerning deferred compensation, the IRS released Revenue Ruling 2014-18, holding that stock-settled stock appreciation rights (SARs) and stock-settled options granted by certain offshore entities will not constitute NQDC for purposes of Internal Revenue Code Section 457A (Section 457A), suggesting that grants of these awards by entities subject to Section 457A should generally remain taxable upon exercise rather than vesting. This client alert describes the impact of these developments in additional detail.

Section 409A Audit Initiative

The Section 409A compliance audit initiative, announced on May 9, targets participation in NQDC arrangements by the 10 most highly paid individuals at fewer than 50 large companies, each of which the IRS previously selected for employment tax audits. The audit focuses on three separate Section 409A compliance areas: (i) compliance with initial deferral election requirements, (ii) compliance with subsequent deferral election requirements, and (iii) and compliance with distributions of deferred compensation (including the "six-month delay" rule applicable to "specified employees" of public companies).

Although limited in scope, this audit initiative suggests a renewed IRS focus on Section 409A compliance and may be a precursor to broader Section 409A compliance audits. In light of this heightened scrutiny, companies are reminded to review their NQDC arrangements to ensure that these arrangements comply in form and operation with the requirements of Section 409A (or applicable exceptions). This review should include both traditional deferred compensation plans and other arrangements that may constitute NQDC under Section 409A's broad scope, including certain severance, equity compensation and other incentive programs. Note also that Section 409A operational and documentary compliance correction programs created under IRS Notices 2008-113, 2010-6 and 2010-80 generally become unavailable once the taxpayer becomes subject to an IRS examination with respect to the NQDC arrangement; meaning that available remedies may be limited if noncompliance is not discovered until the time of an audit.

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Section 457A Revenue Ruling

Background

Section 457A provides that compensation deferred under a NQDC arrangement maintained by any "nonqualified entity" must be included in income once the compensation ceases to be subject to a substantial risk of forfeiture (*i.e.*, upon vesting), unless paid no later than the end of the year following the year in which vesting occurs (in which case the amount would generally be taxable when paid). For purposes of Section 457A:

- An amount is generally vested unless payment of the amount is contingent upon continued employment or service through a future date.[1]
- "Nonqualified entities" subject to Section 457A generally include non-US corporations and partnerships, unless the corporation or substantially all of the partners (as applicable) are subject to either US tax or a comprehensive foreign tax.
- Section 457A's definition of NQDC expands the applicable Section 409A definition to include any right to compensation based on the appreciation in value of a specified number of the company's equity units.

If an amount of compensation subject to a Section 457A NQDC arrangement is undeterminable at vesting, the amount will instead be includible in income when the amount becomes determinable, subject to an additional 20 percent penalty tax plus penalty interest.

Revenue Ruling

Read together, Section 457A's income inclusion timing requirements and NQDC definition appear to treat any nonqualified stock option or SAR issued by a nonqualified entity as NQDC that is taxable upon vesting (rather than exercise), thus severely limiting the utility of these awards. However, Revenue Ruling 2014-18 instead interprets Section 457A to provide that both stock-settled, non-statutory stock options and stock-settled SARs, in either case, which do not constitute NQDC for purposes of Section 409A, will not constitute NQDC for purposes of Section 457A.[2] In reaching this conclusion, the IRS cites legislative history expressing the drafters' intent to exclude stock-settled, nonqualified stock options from the purview of Section 457A and extends this exclusion to stock-settled SARs, reasoning that stock-settled SARs are essentially identical to non-statutory stock options with a net exercise feature.

Notably, this Revenue Ruling is limited to nonqualified stock options and SARs that must, by their terms, be settled in "service recipient stock" (generally stock of the employer or a parent entity), and does not extend to stock rights that may be settled in cash or other property. Nonetheless, Revenue Ruling 2014-18 appears to expand the types of compensation that offshore hedge funds and other nonqualified entities may grant to include stock-settled options and SARs (and, by extension, similar appreciation rights linked to partnership or fund interests). These awards may provide offshore entities with useful compensation alternatives to "phantom carries" and other fee and incentive structures that can create uncertainty under applicable Section 409A and 457A regulations.

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Endnotes

[1] Section 457A provides for the creation of an exception to this narrow vesting rule for "investment assets" meeting certain conditions prescribed in regulations; however, to date, no such regulations have been issued. Note that payments in respect of "investment assets" must generally be paid upon vesting (*i.e.*, disposition of the asset), rather than by the end of the year following the year of vesting.

[2] Stock options and SARs generally do not constitute NQDC for purposes of Section 409A if the awards cover a fixed number of shares of "service recipient stock," have an exercise price per share at least equal to the fair market value of the shares on the grant date and do not otherwise provide for the deferral of compensation.