DEFERRED COMPENSATION FOR THE EMPLOYEES OF TAX INDIFFERENT PRIVATE EQUITY FUNDS

*By Shane M. Tucker**

I. INTRODUCTION 296
II. SECTION 457A OF THE CODE 297
III. SECTION 409A OF THE CODE 298
IV. DIFFERENCES BETWEEN § 409A AND § 457A OF THE CODE 300
   A. *Substantial Risk of Forfeiture* 300
      1. Substantial Risk of Forfeiture Under §§ 83, 409A, and 457 301
      2. Substantial Risk of Forfeiture Under § 457A 302
   B. *Short Term Deferral Rule* 307
   C. *Stock Appreciation Rights* 307
V. TAX CONSEQUENCES RESULTING FROM THE CREATION OF DEFERRED COMPENSATION UNDER § 457A OF THE CODE 309
VI. IMPLICATIONS OF SECTION 457A TO COMMON COMPENSATORY VEHICLES 310
   A. *Management Fee Deferrals* 310
   B. *Transaction, Performance, and Liquidity Bonuses* 313
   C. *Severance Payments* 316
VII. PUBLIC POLICY PROBLEMS 316

---

* Shane Tucker is a Partner at Vinson & Elkins in Dallas. The author would like to thank Casey Fisk for her assistance in the preparation of this article.

I. INTRODUCTION

Late in 2008, the men and women of the 111th Congress attempted to bring some stabilization to the financial markets through the Emergency Economic Stabilization Act of 2008.[1] Embedded in the provisions of this Act is an odd addition to the Internal Revenue Code of 1986 (the "Code") that seems to have very little to do with troubled assets or the bailout of large financial institutions. Section 457A of the Code is identified by the Joint Committee on Taxation report of March 2009 as a "revenue raiser," and the provision effectively eliminates the ability of certain tax indifferent entities to provide deferred compensation to their employees and service providers.[2]

While it is consistent with the general policy of the Code that income and deduction be matched and, therefore, reasonable for the Department of Treasury to want to establish limits on the ability of entities that are not subject to a comprehensive income tax (and hence, have no need for a deduction) to defer the compensation payable to their service providers,[3] § 457A goes much further.[4] By piggybacking on the definition of deferred compensation found in § 409A, § 457A precludes many compensatory arrangements with service providers that are neither intended to provide a service provider with control over income inclusion, nor intended to allow a tax indifferent entity to realize income that it would otherwise pay to a service provider were it a taxable entity.[5]

As will be discussed in this article, § 457A reaches transaction, liquidity, and performance-related bonuses not contingent upon future services by a service provider, as well as severance arrangements, employment agreements, stock appreciation rights, and other arrangements that, prior to the advent of § 409A, would not be conceived by the parties to such arrangements to be a mechanism for the deferral of compensation.[6] The broad definition of deferred compensation utilized by § 457A poses particular challenges to private equity

---

1. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765.

2. STAFF OF J. COMM. ON TAXATION, 110TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS 521 (J. Comm. Print 2009). The Joint Committee on Taxation estimates that § 457A of the Code will raise $25.2 billion dollars over a ten year period beginning January 1, 2009. *Id.* at 607.

3. *See* I.R.C. § 457(f)(1)-(2) (2006 & Supp. 2009) (imposing limits on deferred compensation arrangements of governments and tax-exempt entities).

4. *See generally* I.R.C. § 457A (Supp. 2009).

5. *See* I.R.C. § 457A(a); *see also* I.R.C. § 409A(d)(1)(2006).

6. *See* I.R.C. § 457A.

funds that want to provide compensation to their service providers in a manner that is rationally consistent with their business model without imposing punitive taxes upon their service providers.

This article will summarize the provisions of § 457A and its impact on arrangements that would not be considered by the layman to constitute deferred compensation, discuss strategic alternatives to the design of compensation that would otherwise be subject to adverse tax consequences under § 457A, and analyze whether the putative tax policies motivating the implementation of § 457A are achieved by the statute and its application.

II. SECTION 457A OF THE CODE

Section 457A of the Code generally provides that any compensation that is deferred under a nonqualified deferred compensation plan of a nonqualified entity is includable in the gross income of the service provider at the time at which there is no substantial risk of forfeiture on the rights to such compensation.[7] For purposes of § 457A, the term "nonqualified deferred compensation plan" generally has the same meaning as provided under § 409A(d), with certain important exceptions described in greater detail below.

The term "nonqualified entity," for purposes of § 457A, includes any partnership unless substantially all of its income is allocated to persons other than (1) organizations which are exempt from Title 26 of the United States Code and (2) foreign persons who are not subject to a comprehensive foreign income tax.[8] "Substantially all" of a partnership's income is treated as allocated to eligible persons (i.e., persons who are not either tax-exempt organizations or foreign persons not subject to a comprehensive foreign income tax) only if at least 80% of the gross income of the partnership for such taxable year is allocated to eligible persons.[9] In addition, a "nonqualified entity" includes any foreign corporation unless substantially all of its income is (1) effectively connected with the conduct of a trade or business

---

7. I.R.C. § 457A(a). The statute generally applies to compensation attributable to services performed after December 31, 2008, but imposes limits on the deferral period of compensation attributable to services performed prior to January 1, 2009. *See* I.R.S. Notice 2009-8, 2009-1 C.B. 347.

8. I.R.C. § 457A(b).

9. I.R.S. Notice 2009-8, 2009-1 C.B. 347.

in the United States or (2) subject to a comprehensive foreign income tax.[10]

The inclusion in the definition of "nonqualified entity" (partnerships in which more than 20% of the gross income of the partnership is allocated to ineligible persons intentionally or unintentionally) captures a significant number of private equity funds. Private equity funds frequently have a combination of tax-exempt investors (including qualified retirement plan investors) and foreign investors. Thus, private equity funds will be subject to § 457A to the extent that they constitute nonqualified entities that sponsor deferred compensation.[11]

Unlike § 409A, deferred compensation subject to § 457A cannot be structured in a way that provides for the proper deferral of compensation and the avoidance of adverse tax consequences. Instead, § 457A requires that the service provider include in income the deferred compensation on the first date on which it is no longer subject to a substantial risk of forfeiture (i.e., the date the compensation vests for purposes of § 457A), unless the compensation is not determinable on the vesting date. If an amount is not determinable on the vesting date, taxation will not occur until the time the deferred compensation amounts are determinable, but at that time those amounts will be subject to an additional tax of 20% plus interest.[12] Section 457A, rather than imposing timing limitations on the deferral and distribution of deferred compensation, effectively prohibits deferred compensation by accelerating the tax event of deferred compensation, and potentially, subjecting the compensation to additional taxes if it is not determinable at the time of vesting.

III. SECTION 409A OF THE CODE

In order to properly understand the ramifications of § 457A, a brief description of § 409A is necessary. As the reader is no doubt aware, § 409A imposes a variety of restrictions, limitations, and potentially, additional taxes upon the provision of deferred compensation by a service recipient to certain service providers. Section 457A relies upon the definition of deferred compensation, and to a limited extent, the exceptions thereto, set forth in § 409A and the regulations promulgated thereunder.

10. I.R.C. § 457A(b) (Supp. 2009).

11. I.R.S. Notice 2009-8, 2009-1 C.B. 347 (providing that the sponsor of a nonqualified deferred compensation plan is "any entity or entities which, if the entity paid the amount deferred in cash to the service provider in the relevant taxable year . . . would be entitled to a compensation deduction under U.S. federal income tax principles").

12. I.R.C § 457A(c)(1)(B).

The definition of deferred compensation under § 409A is very simple; any arrangement pursuant to which a service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the arrangement, is *or may be* payable to (or on behalf of) the service provider at a later taxable year, constitutes deferred compensation for purposes of § 409A.[13] Although that general rule is subject to various exceptions, most of which are beyond the scope of this article, it is intended to be a broad definition. A "legally binding right," as utilized in the regulations promulgated under § 409A, does not require that the right of a service provider to compensation be vested or unconditional. It only requires that the right not be subject to the unfettered unilateral discretion of the service recipient to eliminate the right to the compensation payable to a service provider (i.e., without the service provider's consent).[14] Consequently, even a contingent and unlikely payment event subject to onerous conditions potentially constitutes deferred compensation under § 409A.

As will be discussed below, in many circumstances where possible future payment is contingent and there exists a risk that the payment will not be paid (i.e., that the right to payment will be forfeited), provided that that risk of nonpayment is substantial, and that the payment will in all cases be paid within two and one half months following the end of the later of the taxable year of the service recipient or the service provider in which the risk of forfeiture lapses, the payment will fall within a commonly used exception to the general definition of deferred compensation under § 409A known as the "short term deferral rule."[15] Many bonuses contingent upon the achievement of performance goals, or the occurrence of a change in control or other transaction, are frequently exempt from the restrictions and limitations of § 409A under the "short term deferral rule."

Similarly, although severance payments might otherwise fall within the broad definition of deferred compensation under § 409A, § 409A also provides limited exemptions for such payments to the extent they are payable only upon an involuntary termination of employment, fall under certain dollar amounts, and are payable within a certain limited period of time, or if such payments otherwise satisfy the "short term deferral rule."

---

13. *See* Treas. Reg. § 1.409A-1(b)(1) (2007).
14. *See id.*
15. I.R.C. § 409A (2006).

IV. DIFFERENCES BETWEEN § 409A AND § 457A OF THE CODE

While § 457A generally applies to amounts that are deferred compensation for purposes of § 409A, there are a few notable differences. These differences have the effect, intended or unintended, of subjecting unearned compensation and arrangements that would not otherwise constitute deferral compensation for purposes of § 409A to punitive taxation pursuant to § 457A. Although criticisms of the broad definition of deferred compensation established by § 409A could be made, its exceptions, particularly with respect to compensation that satisfies the "short term deferral rule," in most cases allow a service recipient to structure its compensatory arrangements in a manner that satisfies its business goals without subjecting service providers to additional and/or unavoidable taxes.

Unfortunately, the purpose of § 409A differs from that of § 457A. As will be discussed in greater detail below, § 409A addresses a long-standing concern of the Internal Revenue Service ("IRS") regarding the ability of a service provider to control the timing of his income. Section 457A, on the other hand, simply prohibits the deferral of compensation under arrangements sponsored by tax indifferent entities. It requires that vested deferred compensation be immediately taxable (if determinable) and that, in cases in which the deferred compensation is not readily determinable, taxation be delayed to the time that the amount is determinable and the deferred compensation amounts be subject to additional taxes at that time.

As indicated above, § 457A does allow taxation to be delayed with respect to compensation that is subject to a substantial risk of forfeiture within the meaning of § 457A (i.e., until the compensation vests). However, the definition of substantial risk of forfeiture under § 457A differs in significant respects from the concept most tax practitioners are familiar with and that is set forth in § 83 of the Code and the Treasury Regulations promulgated thereunder. This definition is utilized by § 457 and, with certain modifications, § 409A.

A. *Substantial Risk of Forfeiture*

Interestingly, the statutory language defining a substantial risk of forfeiture in each of §§ 83, 409A, 457, and 457A is very similar.[16] While the statutory definitions are almost identical,

---

16. Section 83(c)(1) provides that, "the rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are

the guidance promulgated by the IRS and the Department of Treasury results in significant variation between the concepts as applied under the various statutes.

1. Substantial Risk of Forfeiture Under §§ 83, 409A, and 457

Section 83 of the Code governs the taxation of compensatory property transfers to service providers. Treasury Regulations promulgated under § 83 clarify that a substantial risk of forfeiture exists when rights in the property are conditioned upon either (1) the performance (or the refraining of performance) of substantial services by any person or (2) the occurrence of a condition related to the purpose of the compensatory transfer, and the possibility of forfeiture of the property is substantial if the condition is not satisfied.[17] Three points should be noted with respect to this definition. First, a substantial risk of forfeiture can be based upon a requirement that a service provider continue providing substantial services. Second, a substantial risk of forfeiture can be based upon a requirement that a service provider refrain from performing substantial services (e.g., pursuant to a post termination non-competition agreement whereby a service provider agrees not to perform services for competitors of the service recipient for a specified period of time). Third, conditioning rights in the property on the occurrence of a condition related to the purpose of the property transfer can result in the creation of a substantial risk of forfeiture. For example, if a corporation transferred restricted stock to an employee and conditioned vesting upon the achievement of a specified increase in earnings of the company, such a condition (provided the proper facts and circumstances exist such that the possibility of forfeiture of the restricted stock is substantial if the specified increase in earnings does not actually occur) would create a valid substantial risk of forfeiture for purposes of § 83, even if the service provider was not

---

conditioned upon the future performance of substantial services by any individual." I.R.C. § 83(c)(1)(2006). Section 409A(d)(4) provides that, "the rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual." I.R.C. § 409A(d)(4). Section 457(f)(3)(B) of the Code provides that, "the rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual." I.R.C. § 457(f)(3)(B) (2006). Finally, § 457A(d)(1)(A) provides that, "the rights of a person to compensation shall be treated as subject to a substantial risk of forfeiture only if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual." I.R.C. § 457A(d)(1)(A).

17. Treas. Reg. § 1.83-3(c)(1) (2008).

performing services for the service provider at the time the earnings target is achieved.[18]

The regulatory guidance provided under § 409A modifies the definition of substantial risk of forfeiture under the § 83 regulations in a significant way.[19] Specifically, the flexibility to condition a substantial risk of forfeiture upon a non-competition agreement or other agreement to refrain from performing services was explicitly removed.[20] However, the ability to create a substantial risk of forfeiture by imposing a condition related to the compensation (e.g., requiring the occurrence of a performance condition or a transaction related to the compensation before the compensation would be considered vested) was retained.[21]

Section 457 governs deferred compensation provided by state and local governments and tax-exempt employers.[22] Although the regulations under § 457 do not explicitly define a substantial risk of forfeiture, current guidance from the IRS suggests that forthcoming guidance will generally adopt the regulatory rule under § 409A.[23]

2. Substantial Risk of Forfeiture Under § 457A

Although the statutory language in § 457A(d)(1)(A) is very similar to the statutory language in §§ 83, 409A, and 457, the guidance provided by the IRS with respect to § 457A significantly modifies the meaning of the phrase.[24] Specifically, IRS Notice 2009-8 provides:

> [F]or purposes of section 457A the rights of a person to compensation are subject to a substantial risk of forfeiture only if such person's rights to such

---

18. *See* Treas. Reg. § 1.83-3(c)(2) (2008).

19. *See* Treas. Reg. § 1.409A-1(d)(1) (2007); I.R.C. § 83(c)(1).

20. *See* Treas. Reg. § 1.409A-1(d)(1); I.R.C. § 83.

21. *See* Treas. Reg. § 1.409A-1(d)(1); I.R.C. § 83. Certain additional clarifications regarding the application of the substantial risk of forfeiture concept are also present in the regulations promulgated under § 409A. *See* Treas. Reg. § 1.409A-1(d)(1); I.R.C. § 83. For example, a regulatory prohibition on the extension of a substantial risk of forfeiture beyond the date or time the recipient could have elected to receive the compensation, commonly referred to as a "rolling risk of forfeiture," is included in the § 409A regulations. I.R.S. Notice 2007-62, 2007-2 C.B. 331. These changes, however, are beyond the scope of this article.

22. I.R.C. § 457 (2006).

23. *See* I.R.S. Notice 2007-62, 2007-2 C.B. 331. In Notice 2007-62, the IRS requests comments regarding whether special rules should apply, for the purposes of § 457, to the ability to condition by defining "a substantial risk of forfeiture" in the context that there generally does not exist a profit motive for state and local governments and tax-exempt entities. *Id.*

24. *See* I.R.S. Notice 2009-8, 2009-1 C.B. 347.

> compensation are conditioned upon the future performance of substantial services by such person. Thus, for example, the rights of a person to compensation (including a stock right) are not subject to a substantial risk of forfeiture *merely because those rights are subject to the occurrence of a condition related to the purpose of compensation*, or are conditioned, directly or indirectly, upon the refraining from the performance of services.[25]

Thus, § 457A modifies the definition of substantial risk of forfeiture utilized in §§ 83, 409A, and 457 to eliminate the ability to subject the vesting of compensation to performance conditions or transactions (e.g., an initial public offering) occurring at a time following the termination of the service provider's services.[26]

This change in the meaning of substantial risk of forfeiture[27] can be particularly problematic for private equity funds. It is not uncommon for a private equity fund to condition a significant portion of compensation payable to key employees upon a liquidation event or other long-term performance target. In the context of a private equity fund, "performance" generally requires that the investors get paid, and get paid well, usually in connection with an exit event.

As will be discussed in greater detail below, investors in a private equity fund have little interest in deferring their own returns, and are only interested in deferring the compensation of management employees to the extent necessary to ensure that they (i.e., management) are not paid before the investors themselves. Typically, investors would prefer that the fund turn over its portfolio companies quickly at a profit and provide the investors with return on their capital as soon as possible. What investors do not want to happen is for management employees to pull cash from the portfolio companies and/or the fund prior to the time the investors receive payment, particularly in situations where payment to management is based upon performance of the fund or a portfolio company that could fluctuate between the time of payment to management employees and the time of payment to investors.[28] Consequently, it is very typical for performance-based payments to management employees to be deferred to, and

---

25. *Id.* at Q&A (3) (emphasis added).

26. *Id.*

27. *See* I.R.C. § 83(c)(1) (2006).

28. To be blunt, investors do not want management employees to walk away from the fund or portfolio company prior to the fund winding down and, thereby, potentially receive a better return on their services than investors receive on their capital.

in certain cases for payment to be contingent upon, a liquidity event.[29] However, if an employee terminates employment prior to the occurrence of a liquidity event, § 457A requires that he receive payment early, or if the amount of such payments are not determinable at the time the employment terminates, that the payment be subject to additional taxes at the time the amount becomes determinable.[30] This inconsistency between a substantial risk of forfeiture as traditionally understood, and a substantial risk of forfeiture as understood under § 457A, poses a significant obstacle to compensatory planning for private equity funds.[31]

Another inconsistency between the traditional understanding of a substantial risk of forfeiture and a substantial risk of forfeiture under § 457A, regards the treatment of an involuntary termination of employment. Regulations under § 83, as described above, recognize that a service provider may be considered to perform substantial services even if, upon certain terminations of employment, he is entitled to full vesting of the property subject to the substantial risk of forfeiture. For example, while the § 83 regulations recognize that providing for the forfeiture of amounts only upon a termination for cause would not constitute a substantial risk of forfeiture,[32] informal guidance has traditionally given practitioners comfort that accelerated vesting upon a termination by a service recipient without cause, or a resignation by the service provider prior to a specified date, or upon the death or disability of the service provider, does not invalidate the requirement that a service provider perform substantial services prior to the lapse of the substantial risk of forfeiture (i.e., does not result in the amounts not being subject to substantial risk of forfeiture).[33]

Admittedly, the determination of the existence of a substantial risk of forfeiture for purposes of the regulations under § 83 is very fact intensive. Therefore, for example, whether or not the presence of a good reason provision that allows a service provider to voluntarily resign upon the occurrence of events that would constitute a constructive termination would constitute a substantial risk of forfeiture is

---

29. *See* I.R.S. Notice 2005-1, 2005-1 C.B. 274, Q&A (10)(a).

30. *See* I.R.C. § 457A(c) (2009).

31. *See id.*

32. *See* Treas. Reg. § 1.83-3(c)(2) (2008).

33. *See* I.R.S. Priv. Ltr. Rul. 93-17-010 (Apr. 30, 1993); I.R.S. Priv. Ltr. Rul. 97-12-029 (Mar. 21, 1997). While these private letter rulings do not contemplate vesting upon a constructive termination, such provisions are common and consistent with the principle underlying the rulings. *Id.*

factually sensitive. Ultimately, the test employed by the regulations under § 83 is that the vesting of the property must be conditioned upon the performance of substantial services and the risk of forfeiture (i.e., the risk that those services will not be provided) must be substantial. If a service provider can quit his employment immediately after receiving the property, and upon such termination the property will vest, the property will be treated as vested (and taxable) at the time of the transfer of the property to the service provider because the property was substantially vested at the time of transfer (i.e., because no substantial risk of forfeiture existed).

Section 409A fleshes out these concepts considerably by explicitly noting that compensation is subject to a substantial risk of forfeiture if it is contingent upon the occurrence of "an involuntary separation from service without cause."[34] An "involuntary separation from service without cause" is, as it sounds, a unilateral termination of the service relationship by the service recipient that was not due to the implicit or explicit request of the service provider. This general test includes a resignation by the service provider resulting from "a material negative change to the service provider in the service relationship . . . ."[35] The regulations under § 409A include a safe harbor definition of "good reason" that specifies precisely the nature of the material, negative change that will be deemed to constitute an involuntary termination, and thereby, an event that would satisfy the requirements of a substantial risk of forfeiture.[36]

Intentionally or unintentionally, the definition of "substantial risk of forfeiture" found in Q&A (3) of Notice 2009-8 does not explicitly include the concept of an involuntary termination of employment.[37] It is an odd oversight, but would not seem to preclude the argument that involuntary termination events could be utilized under an arrangement that would be subject to § 457A to defer the vesting of the compensation at issue, given that payment upon an involuntary termination, in the § 83 context, has traditionally been deemed to be a payment event that requires the performance of substantial services even though the § 83 regulations do not expressly address this.

---

34. *See* Treas. Reg. § 1.409A-1(d)(1) (2009) ("[I]f a service provider's entitlement to the amount is conditioned on the occurrence of the service provider's involuntary separation from service without cause, the right is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial.").

35. *Id.* § 1.409A-1(n)(2)(i).

36. *Id.* § 1.409A-1(n)(2)(ii).

37. *See* I.R.S. Notice 2009-8, 2009-1 C.B. 347, Q&A (3).

Further, the omission of the involuntary termination concept from Q&A (3) is odd given that Treasury Regulation § 1.409A-1(a) is explicitly incorporated into the guidance under § 457A, and the § 409A definition of a "substantial risk of forfeiture" is explicitly set forth in Notice 2009-8, Q&A (3), for the most part incorporating the regulation under § 409A, but without mention of vesting upon an involuntary separation from service (and specifically excluding from the definition of "substantial risk of forfeiture" the occurrence of a condition related to the purpose of the corporation).[38]

The selective incorporation of only portions of the regulations under § 409A potentially creates a number of problems in making determinations as to what constitutes deferred compensation for purposes of § 457A. For example, while severance arrangements can be designed to avoid application of § 409A because the regulatory guidance under it specifies that "separation pay plans" do not constitute deferred compensation, similar guidance was not explicitly incorporated into Notice 2009-8, so that guidance may be inapplicable under § 457A.[39] A potentially unintended result of this presumed oversight is that amounts payable in a lump sum upon termination following the performance of substantial services will not be deferred compensation for purposes of § 457A (under the "short term deferral rule" in § 457A), whereas severance payable periodically through December 31 of the second calendar year following the year of the service provider's termination would constitute deferred compensation within the meaning of § 457A regardless of whether or not the compensation otherwise satisfied the requirements of a separation pay plan for purposes of § 409A.[40] It seems odd that a rule intended to part executives from their money would create an incentive to pay those executives earlier. As will be noted in the following paragraph, however, this result is mitigated somewhat by the extended period during which amounts can be paid to a service provider and still fit within the "short term deferral rule" established under § 457A.

---

38. *Id.*

39. On the other hand, Treas. Reg. § 1.409A-1(a) is explicitly incorporated into Notice 2009-8. Because Treas. Reg. § 1.409A-1(a) cannot be understood without reliance upon Treas. Reg. § 1.409A-1(b), is the -1(b) regulation also incorporated? I suppose we can hope so.

40. Although, as discussed below, accelerating payments to executives may be contrary to current public policy surrounding executive compensation, but it is consistent with the putative policy underlying § 457A.

B. *Short Term Deferral Rule*

Closely related to the definition of a substantial risk of forfeiture under both §§ 409A and 457A, is the "short term deferral rule" defined by each. Amounts that qualify as a short-term deferral are not considered to be deferred compensation for purposes of § 409A. As briefly discussed above, the "short term deferral rule" under § 409A provides that if a service provider "actually or constructively receives payment on or before the last day of the applicable two and one-half month period," the compensatory payment will not constitute deferred compensation.[41] The applicable two and one-half month period is defined in the regulations as "the period ending on the later of the 15th day of the third month following the end of the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture[,] or the 15th day of the third month following the end of the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture."[42] Notice 2009-8 extends this short-term deferral period, for purposes of § 457A, to a date "not later than 12 months after the end of the service recipient's taxable year during which the right to the payment of the compensation is first no longer subject to a substantial risk of forfeiture."[43]

C. *Stock Appreciation Rights*

Section 409A generally does not deem a stock appreciation right to constitute deferred compensation provided: (1) the stock appreciation right is granted with respect to service recipient stock; (2) the exercise price may never be less than the fair market value of the underlying stock on the date the right is granted; (3) the compensation payable pursuant to the right cannot be more than the excess of the fair market value of the stock on the date the appreciation right is exercised over the

---

41. Treas. Reg. § 1.409A-1(b)(4) (2009). "Payment" for purposes of this definition is a term of art defined in Treas. Reg. § 1.409A-2(b)(2). Essentially, it is an amount that can be objectively determined under a nondiscretionary formula on a determinable date. *See id.*

42. Treas. Reg. § 1.409A-1(b)(4)(i)(A).

43. I.R.S. Notice 2009-8, 2009-1 C.B. 347, Q&A (4)(a). As will be discussed later, this difference does provide for some design opportunities under § 457A. However, that flexibility is somewhat mitigated by the fact that an amount that might not be deferred compensation for purposes of § 457A, because it is paid within the § 457A short term deferral period, could be deferred compensation for purposes of § 409A, if it is paid during the nine-and-one-half month period that constitutes a § 457A short term deferral but not a § 409A short term deferral.

exercise price with respect to the number of shares fixed on or before the date of grant; and (4) the appreciation right does not include a feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the appreciation right.[44] Regardless of whether the stock appreciation right is settleable in cash or in stock, provided it meets the requirements above, it will not constitute deferred compensation for purposes of § 409A.[45]

Section 457A, however, does not contain a similar exclusion.[46] In fact, § 457A(d)(3)(A) provides that any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of a service recipient will constitute deferred compensation within the meaning of § 457A.[47] "Compensation based on the appreciation in value" is an unfortunately broad term and could be deemed to include a variety of different compensatory vehicles including stock options.[48] However, Notice 2009-8 clarifies that the equity appreciation rights at issue are stock appreciation rights as described in Treasury Regulation § 1.409A-1(b)(5)(i)(B), to the extent such rights are settled in cash.[49] Notice 2009-8 clarifies that certain settled stock appreciation rights and options to purchase equity in non-corporate entities do not constitute deferred compensation subject to § 457.[50] It is not clear from the legislative history or from Notice 2009-8 exactly why stock appreciation rights have been explicitly included in the definition of deferred compensation for purposes of § 457A.[51] But, as will

---

44. *See* Treas. Reg. § 1.409A-1(b)(5)(B) (2009).

45. *Id.*

46. *See* I.R.C. § 457A (2009).

47. *Id.*

48. *See id.*

49. I.R.S. Notice 2009-8, 2009-1 C.B. 347. Early IRS guidance under § 409A deemed stock appreciation rights to be deferred compensation, although publicly traded entities could grant certain stock settled stock appreciation rights. I.R.S. Notice 2005-1, 2005-1 C.B. 274.

50. I.R.S. Notice 2009-8, 2009-1 C.B. 347.

51. The legislative history does, however, contain troubling language that may be inconsistent with Notice 2009-8. *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS 529 (J. Comm. Print 2009). Notice 2009-8 provides that deferred compensation is not intended to include stock options, incentive stock options under § 422 of the Code, the right to purchase stock under an employee stock purchase plan that meets the requirements of § 423 of the Code, or, generally, transfers of property taxable pursuant to § 83 (to the extent the property transfer does not have an associated deferral feature). *See* I.R.S. Notice 2009-8, 2009-1 C.B. 347. However, the legislative history also provides that "[I]t is not intended that [§ 457A] may be avoided through the use of an instrument (such as an option to acquire a partnership interest or a notional principal contract) held or entered into directly or indirectly by a service provider, the value of which is determined in whole

be discussed in greater detail below, the inclusion is consistent with the putative tax policy underlying § 457A.

V. TAX CONSEQUENCES RESULTING FROM THE CREATION OF DEFERRED COMPENSATION UNDER § 457A OF THE CODE

Like § 409A, the negative aspects of § 457A primarily fall upon the service provider. If a deferred compensation arrangement is created by a tax indifferent entity,[52] then the service provider will be taxed on the deferred compensation on the date on which the compensation is no longer subject to a substantial risk of forfeiture within the meaning of § 457A.[53] This is the case whether or not the compensation is actually or constructively received.[54] Thus, § 457A serves to accelerate the income tax recognition event to the service provider who receives a determinable amount of deferred compensation.[55] Although clearly this is not a good result for a service provider who has not received the compensation at issue and who, therefore, will be required to pay his income taxes from some other source, the ramifications of § 457A are much more dire where the compensation is not determinable at the time it is otherwise includable in gross income.[56] If the compensation is not determinable at the time it would otherwise no longer be subject to a substantial risk of forfeiture, a tax is imposed under § 457A of the Code equal to 20% of the amount of the compensation plus interest at the underpayment rate plus one percentage point for the period beginning in the taxable year in which the compensation was first deferred or was first no longer subject to a substantial risk of forfeiture.[57] The tax mirrors the additional

---

or in part by reference to the profits or value (or any increase in the profits or value) of the business of the entity for which the services are effectively provided, particularly when the value of such instrument is not determinable at the time it is granted or received." STAFF OF J. COMM. ON TAXATION, 110TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS 529 (J. Comm. Print 2009). Does this preclude the use of a compensatory profits interest? Presumably not since Notice 2009-8, Q&A (2)(a) incorporates guidance under § 409A that provides the transfer of a profits interest to an employee is treated like the transfer of stock to an employee. *See* I.R.S. Notice 2009-08, 2009-1 C.B. 347; I.R.S. Notice 2005-1, 2005-1 C.B. 279.

52. I.R.S. Notice 2009-8, 2009-1 C.B. 347. Notice 2009-8 essentially provides that the entity sponsoring deferred compensation is the entity that would be entitled to the deduction associated with the compensation were there such a deduction. *See id.* at Q&A (14).

53. *Id* at Q&A (13).

54. *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS 521-22, 528 (J. Comm. Print 2009).

55. *See id.* at 527-28.

56. *See* I.R.S. Notice 2009-8, 2009-1 C.B. 347, Q&A (19)-(20).

57. *Id.* at Q&A (21).

tax imposed by § 409A on non-compliant deferred compensation.[58]

Consequently, if a service provider explicitly defers vested (for purposes of § 457A) compensation pursuant to a deferred compensation plan at a fixed rate of return, the ramifications under § 457A will simply be accelerated taxation of the deferred compensation.[59] However, if the amount deferred is not determinable because it is related to the profits of a portfolio company or an internal rate of return or return on investment to the private equity investors, income recognition will be deferred to the time the amount becomes determinable, but will be subject to additional taxes.[60] As a result, § 457A effectively eliminates determinable deferred compensation and imposes penalties upon deferred compensation that is not determinable.[61] Unfortunately, performance-based compensation paid by a private equity fund that constitutes deferred compensation for purposes of § 457A is frequently not determinable.[62]

VI. IMPLICATIONS OF SECTION 457A TO COMMON COMPENSATORY VEHICLES

The specific decisions made in the construction of § 457A and the guidance promulgated thereunder create a number of interesting implications with respect to common compensatory vehicles.[63] Of particular interest to practitioners working with private equity funds and their portfolio companies are (1) management fee deferrals; (2) transaction, performance, and liquidity bonuses; and (3) severance payments.[64]

A. *Management Fee Deferrals*

Private equity funds are frequently structured to allow general partners or service partners providing management

---

58. *Id.*

59. *Id.* at Q&A (23). The return on a predetermined investment (e.g., the common stock of a portfolio company) will be treated like a fixed rate of return rather than an amount that is not determinable. *See id.* at Q&A (19); Prop. Treas. Reg. § 1.409A-4(b)(2)(iv).

60. I.R.S. Notice 2009-8, 2009-1 C.B. 347, Q&A (21).

61. *Id.*

62. Peter A. Furci et al., *New Deferred Compensation Statutes: Will It Ever End? Private Equity Fund Sponsors Need To Watch Out for Section 457A, New Rule*, 6.1 ENTREPRENEUR 48, 48-49 (2009), *available at* http://www.entrepreneur.com/tradejournals/article/200881546.html.

63. *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS 524 (J. Comm. Print 2009).

64. *Id.*

services to waive their entitlement to management fees that are not yet earned in exchange for a profits interest.[65] Typically, this is provided for in the underlying formation documents of the fund (i.e., the limited liability company agreement or limited partnership agreement).[66] Although practice varies, the partner can frequently, either annually or quarterly (prior to the beginning of the service period attributable to the management fees), make an election whereby a certain percentage or dollar amount of the management fee will not be paid to the partner, and instead the partner will receive a larger portion of future distributions (subject, as applicable, to a threshold value to ensure that the promise to receive future distributions constitutes a compensatory profits interest within the meaning of IRS Revenue Procedures 1993-27 and 2001-43).[67] This practice is also frequently linked to a capital contribution offset where the management fee waiver reduces future capital commitments of the partner.[68]

When § 409A became effective, private equity practitioners questioned whether such a management fee deferral arrangement was a deferral of compensation within the meaning of § 409A.[69] The obvious ramification of a conclusion that an election to receive a profits interest in lieu of management fees is a deferral of compensation would be that management fee deferral elections would need to be made prior to the taxable year in which the services are performed.[70] The second implication of this result would be that either (1) the conveyance of the compensatory partnership profits interest in the subsequent calendar year would be treated as a distribution event for purposes of § 409A, or (2) the distribution events applicable to the profits interest would need to be structured such that they coincided with appropriate distribution events under § 409A of

---

65. Nixon Peabody LLP, Private Equity Alert (Jan. 26, 2005), http://www.nixonpeabody.com/linked_media/publications/PEA_01262005.pdf.

66. *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS 529 (J. Comm. Print 2009).

67. Nixon Peabody LLP, *supra* note 65. The transfer of a compensatory profits interest is not a taxable event, and distributions with respect to the interest retain the underlying character of the gain (i.e., capital or ordinary). Rev. Proc. 2001-43, 2001-2 C.B. 191.

68. *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS 524 (J. Comm. Print 2009). Although the capital contribution is offset, the partner receives no capital account credit. *See* Nixon Peabody LLP, *supra* note 65. The partner is entitled to distributions only out of profits, but those distributions are calculated as though the offset capital contributions were actually made. *See id.*

69. Peter A. Furci et al., *supra* note 62.

70. *See* Treas. Reg. § 1.409A-2(a)(3) (2009).

the Code.[71] Although this conclusion would pose inconvenient design hurdles, there are some practitioners, perhaps overly cautious and concerned about the additional taxes imposed by § 409A, who might opt to ensure these management fee deferrals are designed in compliance with § 409A, and thus, structure the arrangements as described above.[72]

However, there is a reasonable and, in my view, more accurate argument that management fee deferrals do not constitute a deferral of compensation within the meaning of § 409A. Instead, what is occurring in the context of a management fee deferral is that the service provider entitled to the management fee is making a decision prior to the performance of services as to how he or it will be compensated. The amount of the compensation does not change, only its form is altered. Take, for example, an employer who tells an employee that it is willing to pay $200,000 for the services the employee is going to perform in the upcoming year, and that the employee can choose to receive that amount either (1) in cash or in a combination of cash and stock options; (2) in a combination of cash, stock options and a car; (3) in a combination of cash, stock options, a car and gold bricks; or (4) in some other combination of cash and property. Such an election would not be an election to defer compensation, provided that the make-up of the compensation was not somehow itself a vehicle to defer compensation. There are obviously constructive receipt concerns involving such an election, but the choice itself does not create deferred compensation.[73] Thus, provided that the service

---

71. *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS 524 (J. Comm. Print 2009). Specifically, (1) separation from service, (2) disability, (3) death, (4) a specified time, (5) a change of control event, or (6) an unforeseeable emergency, in each case as those events are defined in § 409A and the regulations thereunder. *Id.*

72. *Id.*

73. Although the constructive receipt rules are beyond the scope of this article, the fundamental problem would be that at the point at which the service provider has an unfettered right to receive the compensation (in cash, for example), the IRS might argue that if he could turn his back on that currently taxable cash compensation in exchange for an option which would not be taxed, he would nevertheless be in constructive receipt of the cash, and therefore, taxed on the amount of the cash. Another way of viewing this situation would be that the employee was effectively given the cash, which he used to purchase an option from the employer. Interestingly, although options defer the recognition of income, the income recognized may be considerably more than the cash the service provider, who elected not to be paid, would receive. At least it would be if the service provider chose wisely. Without suggesting that the IRS only pursues those cases providing a bounty to the Treasury, it is worth noting that, in many cases, the economic incentive to pursue a constructive receipt argument does not exist. Unfortunately, the receipt of a compensatory profits interest within the meaning of IRS Revenue Procedures 1993-27 and 2001-43 is not such a situation since the transfer of the interest

provider had not actually or constructively received the cash, his or its election to receive a profits interest instead of a cash management fee should not constitute a deferral of compensation.[74] Cautious practitioners attempting to comply with § 409A prior to the promulgation of § 457A will now find that management fee deferrals have become effectively impossible to structure, unless the practitioner determines the management fee deferral does not constitute deferred compensation.

B. *Transaction, Performance, and Liquidity Bonuses*

As indicated above, a significant portion of the compensation payable to service providers of private equity funds and their portfolio companies tends to be structured as performance compensation, contingent upon the occurrence of a liquidity event. These compensation arrangements are extremely varied but they may take the form of phantom equity, a change in control or liquidity bonus, multi-year performance bonuses, or other compensatory arrangements that are intended to ensure that management employees are compensated well if, and only if, the fund, or its investment in a portfolio company, performs well.

Further, unlike the annual performance bonuses paid to most executives of public companies, many of these arrangements are structured to delay payment to the service provider to the date, if any, at which investors receive the return on their capital investment. That date may occur after the service provider's employment has ended. While there are challenges and risks to designing an arrangement of that nature that will constitute a "short term deferral" within the meaning of § 409A,[75] under § 457A, payments that do not require the performance of substantial services simply will not be deemed to be subject to a substantial risk of forfeiture, and therefore, will constitute deferred compensation to the extent paid outside of the "short term deferral rule" specified by this section.[76] This is even

---

itself is not taxable (although subsequent distributions are). Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191 (clarifying Rev. Proc. 93-27).

74. Obviously, the incentive to receive a profits interest over a management fee will change radically if the current taxation of these interests is altered to require distributions paid pursuant to certain compensatory profits interests be subject to taxation at ordinary income rates. *See supra* note 67 and accompanying text; *see also* H.R. 1935, 111th Cong. (2009).

75. Although liquidity events, changes in control, and other transactions would clearly constitute a condition related to the compensation for purposes of § 409A and Treas. Reg. § 1.409A-1(d)(1) (2009), care does need to be taken to ensure that the arrangement imposes a risk of forfeiture that is substantial.

76. I.R.C. § 457A(d)(1) (Supp. 2009).

more problematic because these arrangements will not be providing for compensation that is determinable at the time the substantial risk for forfeiture lapses; therefore, the service provider will be subjected to additional taxes.

In order to avoid that negative tax consequence, the compensation is likely to be redesigned in one of two ways. First, a post-termination consulting arrangement pursuant to which the executive would be required to perform substantial services could be put into place. This may strike the reader as an abusive arrangement. However, it actually does reflect a frequently seen scenario adopted by private equity funds. If a liquidity event is delayed, certain management employees, after fulfilling a significant period of service, may desire or be entitled to go look for another position. If that happens, even if the employee has otherwise performed the services necessary to receive his compensation, the private equity fund may still want to delay payment to the liquidity event. If the employee has particular information and skills that, while not needed on a day to day basis, are valued by the private equity company and desired up until the occurrence of the future potential liquidity event, the private equity company may decide to enter into a consulting arrangement with the service provider, requiring that the service provider provide services in the future on an as needed basis. It is not an unreasonable additional step to simply require in such a consulting arrangement that the services to be performed are substantial, that the performance-based compensation will be contingent upon the consultant's continued performance of those services, and that the performance-based compensation will be forfeited upon termination of the consulting agreement voluntarily by the consultant. Unfortunately, this is not an ideal solution because if the management employee begins working for another company or private equity fund, he may (1) have difficulty continuing to perform substantial services under the consulting agreement, and (2) run afoul of his duties to his new employer, which could include a non-compete agreement.

Another alternative is simply to pay the employee prior to the liquidity event in connection with a termination of employment. Obviously, the arrangement must be structured such that the compensation does not vest until substantial services have been performed; provided that vesting is contingent upon the performance of substantial services, the accelerated payment would not run afoul of § 457A or the policy underlying the statute.[77] However, in the current environment in which

---

77. *See* I.R.C. § 457A(d)(1)(A).

executive compensation is under scrutiny, and Congress appears to be concerned not only with performance-based compensation but with ensuring that performance-based compensation is actually based on long-term performance,[78] the design changes needed to avoid the negative income tax implications of § 457A run counter to public policy.

Another alternative is to award actual equity to the service provider. A compensatory profits interest, for example, would delay payment to the service provider to the date that payment is made to investors. Further, under guidance issued pursuant to § 409A, the transfer of partnership equity to an employee (including a profits interest) does not create deferred compensation.[79] Currently, this same exception applies under § 457A.[80]

Of course, another solution for any of the difficult compensatory design issues presented by § 457A is to provide a tax gross-up to the service provider. Tax gross-ups are frequently utilized to shield employees from the impact of §§ 280G and 4999 regarding golden parachute payments.[81] Section 457A is similar to those sections in that it essentially prohibits a certain category of payments.[82] If a service provider and service recipient have determined that it is in the best interests of the parties to provide for such a payment, notwithstanding the additional taxes, a tax gross-up could be provided. While this design feature would serve the revenue collection goals of § 457A,[83] it seems at odds with current public policy goals of scrutinizing the amount of compensation paid to executives.[84]

---

78. *See, e.g.,* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, sec. 7001, § 111, 123 Stat. 115, 516-20 (limiting the amount and types of compensation that TARP recipients may pay to top executives).

79. *See* I.R.S. Notice 2005-1, 2005-1 C.B. 274; Prop. Treas. Reg. § 1.409A, 70 Fed. Reg. 57,930, 57,937 (Oct. 4, 2005).

80. *See supra* note 51 and accompanying text. Oddly designed contracts and springing interests appear to be what concerns Congress, not true profits interests. *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS 529 (J. Comm. Print 2009). Even if a tax indifferent entity could hold on to profits and defer distributions, U.S. holders of the interest would still be taxed on the income, assuming they are allocated such income in the partnership agreement. This scenario would not seem to fall within the activity that § 457A attempts to eliminate. *But see supra* note 74 and accompanying text (regarding proposed legislation to tax distributions of certain compensatory partnership interests at ordinary income rates).

81. *See* I.R.C. § 280G (2006 & Supp. 2009); *see* I.R.C. § 4999 (2006).

82. *See id.* §§ 280G, 4999.

83. *See supra* note 2 and accompanying text.

84. Although public concern with executive compensation may primarily be with respect to companies with public stockholders, there also appears to exist a more general

Interestingly, § 457A provides that gain recognized on an "investment asset" is not considered to be a deferral of compensation subject to § 457A.[85] However, the definition of investment asset essentially requires that the investment be passive,[86] which is very unlikely to be the case in connection with compensatory performance arrangements with management employees. What makes those arrangements performance-based is that the management employee is actively managing the asset. While this exception does allow service providers to be treated like other investors, the compensatory purpose behind a conveyance of an interest in the fund to a management employee would be to compensate him if his management of that asset were successful.

C. *Severance Payments*

Due to liquidity concerns, private equity funds may desire to pay severance periodically over time. As indicated above, however, § 457A may limit the ability of a private equity fund to provide periodic severance payments. If periodic payments are paid outside of the "short term deferral period" established by § 457A, they may constitute deferred compensation.[87] Lump sum severance payments, however, provided they are contingent upon the performance of substantial services, would not constitute deferred compensation. Again, this result highlights that the policies that underlie § 457A seem inconsistent with desired public policy regarding executive compensation.[88]

VII. PUBLIC POLICY PROBLEMS

As indicated in the preceding section, § 457A in many ways seems to be at odds with current public policy regarding executive compensation. Nonetheless, the putative policy

---

concern regarding the disparity of compensation payable to executives (of public and private entities) and rank and file employees.

85. *See* I.R.C. § 457A(d)(1)(B) (2009) (defining investment asset for this purpose as "any single asset (other than an investment fund or similar entity)—(I) acquired directly by investment fund or similar entity, (II) with respect to which such entity does not (nor does any person related to such entity) participate in the act of management of such asset (or if such asset is an interest in an entity, in the active management of the activities of such entity), and (III) substantially all of any gain on the disposition of which (other than such deferred compensation) is allocated to investors in such entity.").

86. *See id.*

87. *See supra* notes 39-40 and accompanying text. This statement assumes that the § 409A exception regarding separation pay plans that provide for payment upon an involuntary termination is inapplicable for purposes of § 457A. *See supra* notes 39-40 and accompanying text.

88. A similar criticism could be made of § 409A.

underlying § 457A seems clear. Tax indifferent entities do not have an economic incentive to pay compensation early because the deferral of compensation does not defer their deduction. To illustrate, imagine an individual U.S. taxpayer who provides management services to a fund and desires to defer his management fees for a right to receive the compensation at a fixed time in the future with interest (or maybe the fee is deemed reinvested in the fund as a phantom investment). If the fund is a company subject to U.S. taxation, either as a pass-through entity or as a corporation, holding on to assets that generate income will result in income tax to the entity (or, in the case of a pass-through entity, that income will be passed through to the partners who will be taxed). The fund will not receive a deduction for the compensation paid to the service provider until the service provider is actually paid and taxed on the compensation. This creates a tension in deferred compensation arrangements where the employer has effectively agreed to defer its deduction, and to the extent it holds assets generating income, to be taxed on that income in order for the service provider to defer his income for that period.

It is easy to see that, where the employer is a tax indifferent entity (e.g., an offshore private equity fund not subject to U.S. tax or a comprehensive foreign income tax), this tension is eliminated. And the policy behind § 457 is that deferred compensation should be limited for entities where this tension does not exist. The tax indifferent entity has no economic incentive to pay the compensation at any time other than the time the service provider desires to receive it because holding on to the compensation does not result in income tax to the tax indifferent entity, and paying it will not result in a deduction. In order to properly align the incentives between the two parties in transactions of this nature, § 457A requires that the service provider be taxed early or be subject to additional taxes.

For purposes of tax policy, then, § 457A is not an unreasonable rule. The traditional "matching" principal, where the deduction allocated to the employer occurs at the same time the employee incurs a tax event, is absent in the context of tax indifferent entities. Section 457A is an attempt to make the incentives in such a compensatory arrangement mirror more closely the incentives that would be present if both parties were taxpayers.

The problem, however, is that § 457A does much more than this, as is described in the preceding sections of this article. It places significant limitations on the type of performance-based compensation that can be provided by private equity funds that

fall within the definition of a tax indifferent entity. Because private equity funds generally view performance as performance for the investors, private equity funds desire to delay payments until a liquidity event occurs. However, if that liquidity event does not correspond with the service period of the service provider, § 457A would treat the compensation as deferred compensation. This requires that either the payment be accelerated, which is contrary to the business interest of the private equity fund and contrary to public policy interest in making executive compensation contingent upon performance, or that the parties work around the problem through a consulting arrangement and continued services, which seems to be contrary to the spirit of § 457A. Further, delaying payments to the occurrence of a liquidity event is very much in line with current public policy concerns surrounding the desire to make executive compensation contingent on long-term performance goals, so § 457A again seems to be at odds with current opinion.

The delay in payment observed in the compensatory practices of private equity funds is very much a result of investors demanding actual performance. At the time of a liquidity event, the investors know whether or not the venture has been successful because they see the performance in the returns they receive at that time. Unfortunately, § 457A imposes penalties upon such a design to the extent the liquidity event occurs following the termination of a service provider's employment.

Finally, and interestingly, one of the reasons many private equity funds are tax indifferent is not because they are structured in offshore arrangements intended to somehow shelter taxable income.[89] Many private equity funds solicit investment from pension plans, both those subject to ERISA and those that are not (which would include many government plans), and those pension plans constitute tax-exempt investors for purposes of § 457A. The opportunities to invest in private equity are important to those pension arrangements, and § 457A simply poses another barrier, or at least a complication, to investment by plans into private equity companies. Section 457A is a complication private equity investors might decide they are better off avoiding if they are unable to serve their business

89. It is worth considering whether the threshold of 20% tax indifferent investors is reasonable for purposes of determining if a partnership is a non-qualified entity. Surely if only 50% of the investors were taxed to cover a management deferral, those investors would have an economic incentive to exercise their influence to prevent the deferral.

needs through their compensatory structures with their executive employees.

It is reasonable for Congress to desire to create disincentives for a tax indifferent entity to defer the compensation of its service providers. And while § 457A does create that disincentive, it unfortunately also creates disincentives to a number of reasonable and appropriate compensatory arrangements.