Hoops, LP: Seventh Circuit Denies Deferred Compensation Deduction in Taxable Asset Sale - Upsetting Common Understanding of Timing Rules

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On August 9, 2023, the Seventh Circuit Court of Appeals in *Hoops, LP and Heisley Member, Inc., Tax Matters Partner vs. Commissioner of Internal Revenue*, affirmed the Tax Court?s 2022 decision denying a deduction to a plan sponsor seller in a taxable asset sale transaction for deferred compensation liabilities of the seller expressly assumed in the sale.

Tax Impact of Decision. The deferred compensation liabilities at issue were obligations of Hoops, LP, an accrual-method partnership and the owner and operator of the Memphis Grizzlies. The case involved two sections of the Internal Revenue Code and related Treasury Regulations that implicate the timing of deductions of amounts payable under a non-qualified deferred compensation plan. A potential effect of the decision is that these timing rules ? under many fact patterns ? could operate to deny a deduction for the deferred compensation payments when ultimately made. Under the logic of *Hoops*, this would be the result even though the original plan sponsor, here Hoops, LP, would be required to take those amounts into account as a liability assumption when calculating gain from the sale of its assets.

Tax Rules in Play. The tax rules at issue include Code sections 404(a)(5) and 461. Under Code section 404(a)(5), a deduction for non-qualified deferred compensation is available only in the year in which the compensation is includible in the gross income of a participant: in other words, the year when paid. Under Code section 461 and applicable Treasury Regulations, where liabilities are assumed as part of an asset sale that the selling taxpayer could have deducted but for economic performance, economic performance is deemed to occur as the amount of the liability is property included in the amount realized on the transaction by the taxpayer. The Seventh Circuit reconciled these seemingly at-odds provisions in two ways. First, its concluded that Code section 404(a)(5) is the more specific provision and thus must prevail over the less specific provision. Second, it viewed economic performance as occurring when the players? services were performed, rather than when payment ultimately is made. Thus, it regarded the bar that Code section 461 overcomes ? *i.e.*, ?waiving? economic performance in the context of an asset sale to permit a deduction when a liability assumption is included as gain from the sale ? as inapt in relation to non-qualified deferred compensation.

Other Implications. The Seventh Circuit?s conclusion differs from what has come to represent the common analysis and interpretation of these timing rules in practice. Given this opinion, it will be important for employers to take a fresh look at the effect of transactions on deferred compensation deductions. This is the case both in taxable asset sales, as well as stock sales and mergers where different taxable year end rules (not specific to deferred compensation) impact the deductibility of deferred compensation. This ruling also highlights the importance of understanding whether various types of ?non-qualified? arrangements ? *e.g.*, equity incentives, deferred performance-based bonuses ? are considered deferred compensation under Code section 404(a)(5). This status is based, in large part, on design features of a particular plan or award.

Much of the focus when deferred compensation plans are established is on desired income tax deferral results and Code section 409A compliance. Structuring plans, and sale transaction terms, with compensation deductions in mind is also key, especially after *Hoops*.

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