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IRS Issues Interim Guidance on Taxation of Deferred Compensation Maintained By Certain Partnerships and Foreign Corporations

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This month, the IRS issued Notice 2009-8 as interim guidance on Section 457A of the Internal Revenue Code ("457A"), which imposes immediate taxation, and in certain circumstances a 20-percent penalty plus interest, on deferred compensation arrangements maintained by certain partnerships and foreign corporations. The interim guidance basically elaborates on 457A's statutory scheme, in much the same manner as IRS Notice 2005-1 established guidelines for interpreting Code Section 409A ("409A") after its enactment. Taxpayers may rely on the interim 457A guidance until the IRS issues further guidance, with the IRS promising not to expand 457A's scope other than prospectively after future guidance.

At this juncture, here is what we know:

- Although 457A was designed to target management and incentive fee deferral arrangements entered into by certain offshore hedge funds, the scope of 457A is much broader and may apply to:
 - deferred compensation arrangements maintained by certain foreign corporations for U.S. taxpayers,
 - deferred compensation arrangements maintained by partnerships that have a substantial number of tax-exempt or off-shore limited partners (such as operating partnerships owned by

private equity funds and by non-U.S. portfolio companies owned by private equity funds).

- Close attention to the interim guidance will be the best route toward establishing 457A compliance.
- Plans may be amended before July 1, 2009 to waive any substantial risk of forfeiture service requirement retroactive to December 31, 2008, in order to permit the deferred compensation to avoid the application of 457A.

Overall, 457A should be a concern for any employers that both operate through any non-U.S. entities and have employees or other service providers who are U.S. taxpayers. The key right now is to identify contracts, agreements, plans, or programs that may trip into 457A – and thereby to identify any compliance issues. Our experience with 409A has shown that violations tend to arise only by accident, with the cost of compliance generally piling by comparison those associated with correcting violations.

Scope of 457A

The U.S. Congress enacted 457A on October 3, 2008 as part of the bail-out legislation, the Economic Stabilization Act of 2008. 457A applies to amounts deferred that are attributable to services performed after December 31, 2008.

Existing deferrals for services provided before January 1, 2009 may continue to be deferred but must generally be included in gross income before 2018.

As a general matter, 457A provides that any compensation that is deferred under a “nonqualified deferred compensation plan” of a “nonqualified entity” is includible in gross income when the amounts deferred are no longer subject to a “substantial risk of forfeiture”. However, if the deferred compensation is subject to 457A but “not determinable,” the deferred compensation is not taxed until it becomes determinable, with additional 457A taxes and interest being imposed at that time.

The interim guidance generally defines “nonqualified deferred compensation plan” in the same manner as the definition of such term under 409A. However, plans that “provide a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient” are subject to 457A unless they are:

- statutory options under Code Section 422 or 423;
- nonqualified stock options that are excluded from 409A;
- stock appreciation rights that are excluded from 409A and settled with “service recipient stock” within the meaning of 409A’s regulations; or
- profits interest in a partnership

Thus, for example, cash-settled stock appreciation rights are subject to 457A even if they are exempt from 409A. In addition, like 409A, deferred compensation subject to 457A includes phantom equity arrangements.

The interim guidance excludes “short-term deferrals”, but defines the term differently than 409A as “compensation that is paid no 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.” In addition, the interim guidance limits rights subject to a substantial risk of forfeiture to those rights “conditioned upon the future performance of services”. The statute authorizes the IRS to issue regulations permitting compensation determined by reference to the amount of gain recognized on the disposition of an investment asset to be treated as subject to a substantial risk of forfeiture, and the interim guidance requests comments for implementing this provision.

The following issues for which the IRS has solicited comment may be worth pursuing (which we will be glad to do for interested clients and friends):

- What 457A means by its reference to a “comprehensive income tax treaty”?
- How 457A applies to reimbursement arrangements between U.S. taxpayers and non-U.S. entities?
- How 457A applies to trusts?

We could, of course, comment on other provisions of the interim guidance, and welcome contacts about potential issues that we could bring to IRS attention through our channels.

Service Providers

The definition of service providers subject to 457A is generally the same as service providers subject to 409A with one important exception: Accrual basis taxpayers may be subject to 457A.

Nonqualified Entities

A “nonqualified entity” is:

- any foreign corporation unless substantially all of its income is either effectively connected with the conduct of a trade or business in the United States or subject to comprehensive foreign income tax; and
- any partnership unless substantially all of its income is allocated to persons other than

foreign persons whose income is not subject to a comprehensive foreign income tax or organizations exempt from tax under the Internal Revenue Code.

A foreign corporation means a corporation as defined in Code Section 7701(a) that is not domestic as defined under Code Section 7701(a)(4). Partnership is defined by Code Section 7701(a)(2).

The determination of whether an entity is a nonqualified entity (and whether, as explained in the next paragraph, the nonqualified entity sponsors the nonqualified deferred compensation plan) is made as of the last day of each of the service provider's taxable years in which the nonqualified deferred compensation is no longer subject to a substantial risk for forfeiture and remains deferred. For example, if the plan sponsor becomes a nonqualified entity during a service provider's taxable year and is a nonqualified entity as of the last day of the service provider's taxable year, the deferred compensation is subject to 457A and includible in income for that year to the extent the amounts are no longer subject to a substantial risk of forfeiture. On the other hand, if the plan sponsor ceases to be a nonqualified entity during a service provider's taxable year, and is not a nonqualified entity as of the last day of the service provider's taxable year, the deferred compensation is not subject to 457A for that taxable year.

A nonqualified entity sponsors the nonqualified deferred compensation plan if it is an entity which, if it paid the amount deferred in cash to the service provider would be entitled to a compensation deduction under U.S. federal income tax principles.

Foreign corporations with substantially all income subject to a comprehensive foreign income tax

Substantially all of the income is subject to a comprehensive foreign income tax if, for the taxable year of the foreign corporation ending with or within the service provider's relevant tax year:

- either (1) the foreign corporation is eligible for the benefits of a comprehensive income tax treaty between the United States and its country of residence or (2) the foreign corporation demonstrates to the satisfaction of the Secretary of the Treasury that it is a resident for tax purposes in a foreign country that has a comprehensive income tax; and
- the foreign corporation is not taxed by the foreign corporation's country of residence under any arrangement that is materially more favorable than the corporate income tax otherwise generally imposed by such country.

A comprehensive income tax treaty is any income tax treaty in force with the United States on the date of publication of the interim guidance other than the income tax treaties with Bermuda and the Netherland Antilles.

The interim guidance includes a special rule whereby substantially all of the income of a foreign corporation will not be treated as a subject to comprehensive foreign income tax if the foreign corporation's taxable income determined under this laws of its country of residence wholly or partially excludes nonresidence source income and the aggregate amount of nonresidence source income of the foreign corporation that is excluded for the relevant tax year exceeds 20 percent of the foreign corporation's gross income.

Foreign corporations with substantially all income effectively connected to US trade or business

Substantially all of the income of a foreign corporation is treated as effectively connected with the conduct of a trade or business within the United States if, for the taxable year of the foreign corporation ending with or within the service provider's relevant taxable year, at least 80 percent of the foreign corporation is effectively connected with the conduct of a trade or business in the United States under Code Section 882 and the regulations thereunder that is not exempt from U.S. federal income tax pursuant to a United States treaty obligation (for example, because the

income is not attributable a permanent establishment).

Partnerships

A partnership will not be a nonqualified entity for a taxable year if it has income and at least 80 percent of its gross income is allocated to "eligible persons". Gross income is allocated to an eligible person to the extent:

- gross income that is derived in an unrelated trade or business described in Code Section 512(a) is allocated to an organization subject to tax for unrelated trade or business taxable income ("UBTI") under Code Section 511;
- gross income that is effectively connected with the conduct of a trade or business in the United States under Code Section 871(b) or 882(a) is allocated to a person subject to U.S. federal income tax on such income and not exempt from U.S. federal income tax pursuant to a U.S. treaty obligation;
- gross income is allocated to a United States person as defined under Code Section 7701(a)(3) other than (1) a tax-exempt organization, (2) a domestic partnership or (3) a trust or estate except to the extent the trust or estate is subject to U.S. federal income tax in respect of such income and such income is neither included in the gross income of a beneficiary under Code Section 652 or 662 nor paid or permanently side aside for a charitable purpose under Code Section 642(c); or
- gross income that is not effectively connected income is allocated to a person that is not a United States person who is subject to a comprehensive foreign income tax with respect to such income.

The interim guidance provides detailed rules for determining the partnership's income and allocations for this requirement.

Timing and Amount of Income Inclusion

Deferred compensation subject to 457A will be included in the service provider's taxable year in which it is no longer subject to substantial risk of forfeiture. However, if the amount of the deferred compensation is "not determinable" the deferred compensation will not be includible in the service provider's gross income until the amount of the deferred compensation becomes determinable. The interim guidance describes when deferred compensation is not determinable and this generally occurs when the amount of the payment (and not the timing of the payment) is unknown because it is based upon factors that remain variable as of the end of the year (e.g., annual profits for a calendar year that has not yet ended). If income inclusion is delayed because the amount deferred was not determinable, a penalty tax of 20 percent will be assessed when the income is included. In addition, interest will be assessed at the statutory underpayment rate plus one percent on the underpayment that would have occurred had the deferred compensation been includible in gross income when first deferred or, if later, the first taxable year in which the deferred compensation is no longer subject to a substantial risk of forfeiture.

The amount includible in income under 457A is determined under the rules applicable to determine amounts includible in income under 409A.

Effective Dates

Section 457A applies to amounts deferred that are attributable to service performed after December 31, 2008. Deferred amounts attributable to services performed in 2008 and earlier years will not be subject to 457A if they are included in gross income in the later of the last taxable year beginning before January 1, 2018 or the first taxable year in which the amounts are no longer subject to a substantial risk of forfeiture.

The interim guidance provides the following rules for allocating the compensation deferred to the year(s) the services are performed:

- If a service provider obtains a legally binding right to compensation on before December 31, 2008, and as of December 31, 2008 the plan provides for payments under a formula tied to service or compensation in a specific year or years, the compensation will be attributable to that year or years.

Example 1: Employee obtains on December 31, 2008 a legally binding right to be paid \$400,000 on February 1, 2010, the compensation is not attributable to services performed after December 31, 2008.

Example 2: Employee obtains on December 31, 2007 a legally binding right to be paid on February 1, 2010 an amount equal to 10% of employee's salary during 2008 and 2009. Employee's salary for both years is the same. The deferred compensation will be pro rated 50 percent for 2008 and 50 percent for 2009.

- If, based on the terms of the plan in effect as of December 31, 2008, a service provider's right to the compensation is subject to a substantial risk of forfeiture in the form of the requirement to perform substantial services after December 31, 2008, the deferred compensation is generally allocated over the period the service provider is required to perform the substantial services on a pro rata basis. For example, if an employee obtains on January 1, 2008 a right to an amount payable on January 1, 2014 but only if employee continues to perform services through December 31, 2010, one-third of the deferred amount is attributable to services performed prior to January 1, 2009.

Plans may be amended before July 1, 2009 to waive any substantial risk of forfeiture service requirement retroactive to December 31, 2008 to permit the deferred compensation to avoid the application of 457A.

- If, based on the terms of the plan in effect as of December 31, 2008, compensation is not attributable to services performed in a particular period, the compensation is generally attributable to services performed during the year in which the employee obtains the legally binding right to compensation.

Coordination with 409A

The interim guidance contains a number of rules coordinating the application of 457A with 409A when both sections apply to the same deferred compensation, including:

- Income inclusion under 457A is treated as payment for purpose of 409A's short-term deferral rule;
- With respect to deferred amounts attributable to services performed before January 1, 2009, a change in the time and form of payment to confirm the date of distribution to the date the amount may be required to be included in income under 457A will not violate 409A provided the change in time and form of payment is made no later than December 31, 2011; and
- With respect to deferred amounts attributable to services performed on or after January 1, 2009, such amounts should generally not constitute deferred compensation subject to 409A because they will be paid within 409A's short-term deferral rule as explained above. However, there may timing differences where amounts subject to 409A may subsequently become subject to 457A or vice versa. To address these timing differences, payment of an amount subject to 409A in the year in which the amount becomes includible in income under 457A will not violate 409A.

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If you have any questions concerning 457A, please do not hesitate to contact any of the following Paul Hastings lawyers:

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