January 29, 2009

TAX ALERT

IRS ISSUES INTERIM GUIDANCE UNDER SECTION 457A

EXECUTIVE SUMMARY

On October 3, 2008, new Section 457A was added to the Internal Revenue Code by the Emergency Economic Stabilization Act of 2008. As discussed in our client alert, "New Section 457A, Which Limits Deferral of Offshore Compensation, Is Signed into Law," Section 457A imposes significant restrictions on the ability of U.S. taxpayers to defer compensation earned from certain tax indifferent parties, including managers of offshore hedge funds. Generally, under Section 457A, taxpayers are required to include in income compensation that is deferred under a "nonqualified deferred compensation plan" of an entity (including both domestic and foreign partnerships and foreign corporations) that is not subject to a general income tax regime (a "nonqualified entity"), provided that the compensation is not subject to a "substantial risk of forfeiture."

On January 8, 2009, the IRS released Notice 2009-8, which provides interim guidance to assist taxpayers in complying with Section 457A while the Treasury Department and the IRS consider further guidance. The Notice states that any future guidance that would expand the coverage of Section 457A will be prospective.

As discussed more fully below, Notice 2009-8—

- confirms that Section 457A applies to a broader range of service recipients than Section 409A (e.g., it applies to accrual method taxpayers) and that Section 457A is not limited exclusively to hedge fund managers and service providers to offshore funds.
- restricts the ability of entities to avoid Section 457A by reorganizing in jurisdictions that have a comprehensive income tax treaty with the United States if such entity is then taxed under a regime that is materially more favorable than the income tax otherwise imposed by such jurisdiction.

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- clarifies that "nonqualified deferred compensation" (NQDC) generally has the same meaning under Section 457A as under Section 409A. However, unlike in the case of Section 409A, stock appreciation rights that are settled in cash will constitute NQDC for Section 457A purposes. Since Section 457A applies to accrual method taxpayers, the use of so-called KeySOP arrangements (i.e., stock options with a deeply discounted exercise price) generally will not comply with Section 457A unless settled within Section 457A's short-term deferral rule (as described below).

- coordinates Sections 457A and 409A, including providing important transition relief permitting changes in the time and form of payment of pre-2009 deferred compensation amounts without violating Section 409A or losing Section 409A grandfathering benefits for such amounts, so long as any such changes are made on or before December 31, 2011. However, the Notice does not appear to permit acceleration of NQDC to a period earlier than the last year in which amounts would otherwise be taxable under Section 457A (e.g., for a calendar year taxpayer, if deferred amounts are currently payable in 2025, the Notice would allow acceleration to 2017, but not necessarily earlier than 2017).

- defines "nonqualified entities" through detailed rules that require evaluation of applicable income tax treaties, foreign income tax systems, income sourcing rules, partnership allocation rules, expense allocation rules and certain other principles and rules. It is important to understand that Section 457A could apply to service providers to a domestic partnership, unless substantially all (80 percent) of the partnership's gross income is allocated to "eligible persons," as more fully described below.

- provides that the test for "nonqualified entity" status is applied as of the last day of the service provider's taxable year in which the NQDC is no longer subject to a substantial risk of forfeiture. The Notice does not specifically address whether this rule applies to grandfathered amounts under Section 457A. Assuming that this rule does apply to such grandfathered amounts (which is likely the case), if the NQDC vested when the entity was a "nonqualified entity," any change in the status of such entity seemingly would have little effect on when the grandfathered amounts would be included in income under Section 457A.

- explains when deferred compensation amounts are "attributable to" pre-January 1, 2009 services for purposes of applying the Section 457A transition rules. In this regard, special transitional rules allow a service recipient to waive post-December 31, 2008 vesting conditions such that the amount subject to the vesting conditions should be treated as fully attributable to pre-January 1, 2009 services. Any such election must be made in writing and effective prior to July 1, 2009.

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DETAILED DISCUSSION OF GUIDANCE PROVIDED BY THE NOTICE

TO WHOM DOES SECTION 457A APPLY?

In general, Section 457A may apply to any service provider that is an individual, corporation or partnership and that provides services to a "nonqualified entity." A service provider's method of accounting is irrelevant for purposes of determining whether Section 457A applies (e.g., it may apply to accrual method taxpayers). The Notice confirms that, as in the case of Section 409A, Section 457A does not apply to certain independent contractors with multiple unrelated clients, such as law firms. This exception, however, does not cover independent contractors that provide management services (including investment managers).

WHAT IS A "NONQUALIFIED ENTITY"?

A "nonqualified entity" is any foreign corporation, unless substantially all of its income is either (i) effectively connected with the conduct of a trade or business within the United States or (ii) subject to a comprehensive foreign income tax. A nonqualified entity also includes any partnership (including a domestic partnership), unless substantially all of its income is allocated to persons *other than* (i) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax and (ii) organizations which are exempt from U.S. federal income tax. The Notice clarifies that the U.S. tax classification (rather than the local law or corporate classification) controls in determining whether an entity is a "foreign corporation" or a "partnership" for purposes of Section 457A. For the purpose of determining whether an entity is a nonqualified entity, "substantially all" means 80 percent.

Foreign Corporations

A foreign corporation will satisfy the "effectively connected" test only if at least 80 percent of its gross income is effectively connected with the conduct of a trade or business within the United States ("ECI"), and the income is not exempt from U.S. federal income tax under a treaty obligation of the United States. Thus, for example, if 100 percent of a foreign corporation's income is ECI, but the income is not taxed because it is not attributable to a "permanent establishment" under a U.S. income tax treaty, the foreign corporation will not satisfy this test.

Most hedge funds take the position that they are not engaged in a U.S. trade or business, and, therefore, a typical offshore hedge fund vehicle does not derive "substantially all" of its income from ECI. Accordingly, the crucial issue in determining whether a typical offshore hedge fund vehicle (which invariably will be classified as a foreign corporation for U.S. tax purposes) is a nonqualified entity under Section 457A is whether substantially all of its income is "subject to a comprehensive foreign income tax." The Notice provides that a foreign corporation will be considered subject to a comprehensive foreign income tax if it is (i) eligible for the benefits of a comprehensive income tax treaty between its country of residence (other than Bermuda and the Netherlands Antilles) and the United States, taking into account any limitation on benefits provision or other condition or restriction

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under the treaty,[1] and (ii) not taxed by its country of residence under any regime or arrangement that is "materially more favorable" than the corporate income tax otherwise generally imposed by such country. The second prong of this test, which disqualifies a foreign corporation that is entitled to special benefits under a comprehensive income tax regime, will impede the widely discussed planning device of reorganizing an otherwise nonqualified entity as an entity that is not subject to Section 457A, since the reorganized entity typically will be subject to corporate income tax at a low rate in its home jurisdiction. This prong of the test is not described in Section 457A or the legislative history, and it is unclear whether, if challenged, this prong will be upheld as a valid exercise of regulatory authority.

Even if a foreign corporation satisfies both prongs of the test described immediately above, the foreign corporation will not be treated as subject to a comprehensive foreign income tax if (i) the laws of its country of residence exclude, in whole or in part, its "nonresidence source income" (e.g., dividends from subsidiaries incorporated in other jurisdictions) from its taxable income and (ii) the aggregate amount of its nonresidence source income that is excluded for the taxable year exceeds 20 percent of its total gross income. A foreign corporation's taxable income will be treated as excluding an item of nonresidence source income if its taxable income "does not include such income, or excludes such income by means of exemption, exclusion (including an exclusion from gross income), deduction (including a dividends received deduction or dividends paid deduction) (or similar provision)), by means of taxation of such income at a rate of tax less than 50 percent of the generally applicable rate, or by other means." The scope of this test is unclear but appears to be quite broad. Dividends are not treated as "bad" income for purposes of the 20 percent test, so long as they are received from a U.S. corporation or from a non-U.S. corporation that itself meets the comprehensive foreign income tax test or are ECI that is not exempt from U.S. federal income tax under a treaty obligation of the United States.

Partnerships

A partnership, whether domestic or foreign, will be treated as a nonqualified entity unless 80 percent or more of its income is allocated to "eligible persons." Generally, partnership gross income will be treated as allocated to an "eligible person" if it is allocated (directly or through one or more tiered partnerships) to (i) a U.S. individual or corporation (and certain other U.S. persons); (ii) a U.S. tax-exempt entity, to the extent such gross income is derived in an "unrelated trade or business" and is taxable to such entity under the unrelated business taxable income rules; (iii) a non-U.S. person, to the extent such gross income represents ECI and is not exempt from U.S. federal income tax under a U.S. income tax treaty; or (iv) a non-U.S. person who is subject to a comprehensive foreign income tax with respect to the gross income (determined under principles similar to those discussed above, but without regard to the 20 percent test).

[1] As an alternative to proving eligibility for treaty benefits, the foreign corporation may demonstrate to the satisfaction of the Treasury Secretary that it resides in a foreign country that has a comprehensive income tax. However, the Notice provides no guidance as to how to demonstrate comprehensive income tax status to the Treasury Secretary.

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WHEN IS NONQUALIFIED ENTITY STATUS DETERMINED?

The Notice provides that the determination of whether an entity is a nonqualified entity is made as of the last day of each of the service provider's taxable years in which NQDC is no longer subject to a substantial risk of forfeiture and remains deferred. Thus, 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 such year, compensation amounts deferred under the plan are subject to Section 457A for such year. Similarly, if a plan sponsor is a nonqualified entity during a service provider's taxable year but ceases to be a nonqualified entity during such year and is not a nonqualified entity on the last day of such year, compensation amounts deferred under the plan are not subject to Section 457A for such year.

WHEN IS NQDC INCLUDIBLE IN GROSS INCOME UNDER SECTION 457A?

Generally, any compensation that is deferred under a NQDC plan of a nonqualified entity is includible in gross income under Section 457A when there is no substantial risk of forfeiture of the rights to such compensation, so long as such compensation is attributable to services performed after December 31, 2008. However, if any amount of deferred compensation is not determinable at the time such amount would otherwise be includible in gross income under Section 457A, such amount must be taken into account when it becomes determinable, subject to a 20 percent penalty tax *and* an interest charge (at the underpayment rate plus 1 percent) as if such amounts had been includible in income as of the time they were no longer subject to a substantial risk of forfeiture. Under the Notice, an amount is not determinable when the amount of the payment is unknown at the end of the taxable year because certain factors remain variable (such as future profits).

WHAT IS A "SUBSTANTIAL RISK OF FORFEITURE" FOR SECTION 457A PURPOSES?

Section 457A contains a more restrictive definition of "substantial risk of forfeiture" than Section 409A. Specifically, Section 457A provides that a person's right to compensation is treated as subject to a substantial risk of forfeiture only if the right is conditioned upon the "future performance of substantial services by any individual" and not merely upon performance-based measures. Importantly, the Notice provides that a substantial risk of forfeiture imposed after the legally binding right to the compensation arises is disregarded (unless the amount of the compensation materially increases). For example, if a bonus plan provides for an election between a current cash payment or restricted stock units with a present value that is materially greater (disregarding the risk of forfeiture) than the present value of the cash payment and that will be forfeited absent the continued provision of services for a period of years, the right to the restricted stock units, generally, is treated as subject to a substantial risk of forfeiture for Section 457A purposes.

DOES SECTION 457A HAVE A "SHORT-TERM DEFERRAL" EXCEPTION?

Like Section 409A, Section 457A has a "short-term deferral" exception. However, under Section 457A, the short-term deferral rule generally applies if payment of compensation is made no later than 12 months after the end of the service recipient's taxable year during which the right to the payment of

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such compensation is no longer subject to a substantial risk of forfeiture. Thus, if on January 1, 2009, an employee is provided a right to a future payment of compensation if he or she continues providing services to his or her employer through January 1, 2011, and the amount is paid out not later than 12 months after the end of the employer's taxable year that includes January 1, 2011, the compensation is not subject to Section 457A. Assuming the employer has a calendar year-end, the last day on which the compensation could be paid out without becoming subject to Section 457A would be December 31, 2012 (i.e., 12 months after the end of the employer's 2011 taxable year).

WHAT TYPES OF EQUITY-BASED AWARDS ARE EXEMPT UNDER SECTION 457A?

In general, other than cash-settled stock appreciation rights, the same exceptions provided in Section 409A relating to stock rights apply. As such, Section 457A should not apply to a compensatory grant of incentive stock options under Section 422 of the Code, non-qualified stock options and stock-settled stock appreciation rights with at least a fair market value strike price.

In addition, the Notice states that, with respect to an arrangement between a partner and a partnership, taxpayers may rely upon the applicable guidance under Section 409A, which provides that taxpayers may treat the issuance of a partnership profits interest (or an option to purchase such an interest) that is granted in connection with the performance of services as not resulting in a deferral of compensation, so long as the issuance does not result in income inclusion by the service provider at the time of issuance. Therefore, absent changes to the applicable guidance under Section 409A or to the tax treatment of compensatory grants of partnership profits interests, Section 457A generally should not apply to a grant of such an interest or an option to purchase such an interest.

WHAT IS THE SCOPE OF SECTION 457A TRANSITION RELIEF?

Section 457A generally applies only to deferred compensation amounts attributable to services performed after December 31, 2008. Under transition relief, deferred compensation attributable to services performed before January 1, 2009 may continue to be deferred until the *later* of (a) 2017 (or, in the case of fiscal-year entities, until the last taxable year beginning before January 1, 2018) or (b) the first taxable year in which such amounts are no longer subject to a substantial risk of forfeiture for Section 457A purposes.

The Notice provides that a change in the time and form of payment of deferred compensation amounts attributable to pre-2009 services made solely to conform the date of distribution of such amounts to the date such amounts may be required to be included in income under Section 457A will not be treated as an "impermissible acceleration" under Section 409A, so long as such change is established in writing and effective on or before December 31, 2011. Any such change also will not affect the status of NQDC amounts that are grandfathered under Section 409A.

However, the Notice does not expressly permit acceleration of deferred compensation to a period earlier than the last year in which amounts would otherwise be taxable under Section 457A (e.g., for a calendar

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year taxpayer, if deferred amounts currently are payable in 2025, the Notice would allow acceleration to 2017, but not necessarily earlier than 2017).

For purposes of the foregoing, the Notice generally provides guidance to enable taxpayers to determine whether deferred compensation amounts are "attributable" to particular service years, which in turn allows taxpayers to apply the effective date and transition relief provisions of Section 457A. In general, with respect to unvested amounts, the Notice requires a proration. However, a special transitional rule allows a service recipient to waive post-December 31, 2008 vesting conditions, such that the amount subject to such vesting conditions could be fully attributable to pre-January 1, 2009 services. Any such election must be in writing and made prior to July 1, 2009.

IRS Circular 230 Notice. This communication is not given in the form of a covered opinion, within the meaning of Circular 230 issued by the United States Secretary of the Treasury. Thus, we are required to inform you that you cannot rely upon any tax advice contained in this communication for the purpose of avoiding United States federal tax penalties. In addition, any tax advice contained in this communication may not be used to promote, market or recommend a transaction to another party.

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