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## Interim Guidance on the Taxation of Deferred Compensation Under Section 457A of the Internal Revenue Code

Section 457A of the Internal Revenue Code of 1986, enacted on October 3, 2008, generally provides that compensation deferred under a “nonqualified deferred compensation plan” of a “nonqualified entity” is included in gross income when it is no longer subject to a “substantial risk of forfeiture,” even if it is actually paid at a later date. Section 457A was intended to target the deferral of management and performance fees of certain offshore hedge funds. However, Section 457A applies more broadly to deferred compensation arrangements established by (i) certain non-U.S. corporations and (ii) certain partnerships that have a significant number of tax-exempt or non-U.S. partners. Accordingly, any non-U.S. corporation, or partnership significantly owned by non-U.S. persons, that directly employs U.S. persons needs to consider the potential application of Section 457A. On January 8, 2009, the Internal Revenue Service issued Notice 2009-8 to provide interim guidance on the application of Section 457A. To understand this guidance, it should be read in conjunction with proposed regulations under Section 409A of the Internal Revenue Code that address the calculation of amounts includible in gross income.

Key “takeaways” from the interim guidance:

- Whether an entity will be a “nonqualified entity” under Section 457A is determined on an annual basis and may change from year to year.
- Multinational corporations with global deferred compensation arrangements may find that compensation under those plans payable to U.S. taxpayers employed by foreign subsidiaries is subject to Section 457A, while the same compensation payable to U.S. taxpayers working in the U.S. is not.
- The rules for determining whether a partnership is subject to Section 457A are complex and require an employer to look through the partnership to the status of the partners.
- A right to compensation is subject to a substantial risk of forfeiture only if the compensation is conditioned upon the future performance of substantial services, a definition that is narrower than that used for purposes of Section 409A and Section 83.
- Nonqualified deferred compensation under Section 457A includes cash settled stock appreciation rights and performance fees paid in respect of hedge fund

side pocket arrangements (unless structured as a profits interest in a partnership).

- The relationship between Section 409A and Section 457A is complex and not necessarily logical.

The following provides, in Q&A format, a more complete review of this guidance.

## What Entities Are Subject to Section 457A?

Section 457A applies to deferred compensation arrangements sponsored by “nonqualified entities.” Determining whether an entity is a “nonqualified entity” requires an analysis of the structure of the entity, the tax rules and income tax treaties applicable to the entity or its partners, and its sources of income. Further, the determination of whether an entity is a nonqualified entity is made as of the last day of the service provider’s taxable year in which the nonqualified deferred compensation is no longer subject to a substantial risk of forfeiture. Thus, an entity’s status as a nonqualified entity may change from year to year.

## Foreign Corporations

A non-U.S. corporation is considered a “nonqualified entity” unless substantially all of its income is either (i) effectively connected with the conduct of a trade or business in the U.S. or (ii) subject to a “comprehensive foreign income tax.”

Notice 2009-8 provides that a non-U.S. corporation will satisfy the first prong of this test if at least 80% of its gross income is effectively connected with the conduct of a U.S. trade or business. With respect to the second prong of the test, substantially all of a foreign corporation’s income is considered subject to a comprehensive foreign income tax if:

- The corporation is eligible for the benefits of a comprehensive income tax treaty with the U.S. as of January 26, 2009 (other than the income tax treaties with Bermuda and the Netherlands Antilles)

or otherwise demonstrates that its country of residence has a comprehensive income tax;

- The corporation is not taxed by its country of residence under an arrangement that is materially more favorable than the corporate income tax generally imposed by that country; and
- The aggregate amount of the corporation’s “nonresidence source income” that is excluded from its gross income (by deduction, exemptions or otherwise) for the relevant taxable year does not exceed 20% of the corporation’s gross income for that year.

## Partnerships

A partnership is considered a “nonqualified entity” unless substantially all (*i.e.*, 80%) of its gross income is allocated to “eligible persons,” which generally are persons other than (i) foreign persons not subject to a comprehensive foreign income tax and (ii) persons who are exempt from U.S. federal income tax. The determination of whether a partnership is a nonqualified entity is made as of the last day of each of the service provider’s taxable years based on the allocations of gross income by the partnership for the partnership’s taxable year ending with or within the service provider’s taxable year.

For purposes of the “eligible persons” test, foreign persons will generally be considered subject to comprehensive foreign income tax if:

- The foreign person takes income into account on a current basis under the income tax laws of its country of residence, regardless of whether the income is actually distributed to such person;
- The foreign person is an entity that is not fiscally transparent under the laws of its jurisdiction;
- The foreign person is eligible for the benefits of an income tax treaty with the U.S. (other than the income tax treaties with Bermuda or the Netherlands Antilles);

- The foreign person is not taxed by its country of residence under an arrangement that is materially more favorable than the corporate income tax generally imposed by that country; and
- The income in question is not excluded from the foreign person's taxable income by means of exemption, exclusion, deduction, taxation at a rate less than 50% of the generally applicable rate, or otherwise.

Notice 2009-8 provides complex and detailed rules for determining how the income of a partnership should be allocated to "eligible persons." In particular, for partnerships with tiered ownership, gross income that is allocated to a partner may be treated as allocated to the partner's direct or indirect owner if the owner takes the income into account on a current basis for purposes of its country's income tax laws, regardless of whether the income is actually distributed to the owner.

### Who Is the Plan Sponsor?

Although the statutory text does not use the term "plan sponsor," the proposed regulations provide that it is the status of the "plan sponsor" as a nonqualified entity that determines whether deferred compensation is potentially subject to Section 457A. Under the proposed regulations, the plan sponsor is the entity that, if it paid the deferred amount in cash to a service provider for the relevant taxable year, would be entitled to a compensation deduction under U.S. federal income tax principles. The entity that has the legal obligation to pay a deferred amount may or may not be treated as the plan sponsor under this standard.

This standard raises a number of issues. For example, a large multinational corporation may have a global deferred compensation arrangement that applies to individuals employed by subsidiaries in multiple jurisdictions. If one of the subsidiaries is a nonqualified entity, the deferred compensation payable to U.S. taxpayers who are compensated by that nonqualified entity would be subject to Section 457A. This result

applies even if the formal legal obligation to pay the deferred amount is an obligation of the parent corporation, and even if the parent corporation is not a nonqualified entity. On the other hand, that same compensation paid to a U.S. taxpayer working for a U.S. subsidiary would not be subject to Section 457A, even if the obligor under the terms of the plan is a nonqualified entity.

In the case of a plan sponsored by a foreign corporation for the benefit of employees of its U.S. subsidiary, the U.S. subsidiary would be treated as the sponsor of the plan for purposes of Section 457A because it would be entitled to the compensation deduction for amounts paid to its employees. As such, compensation payable to employees of the U.S. subsidiary should not be subject to Section 457A, since the deemed sponsoring entity is not a nonqualified entity. However, the Treasury Department has requested comments regarding whether an arrangement under which a nonqualified entity reimburses the U.S. subsidiary's compensation costs should result in the U.S. taxpayer being treated as a nonqualified entity. If Treasury determines that reimbursement arrangements taint the U.S. subsidiary, the fact that a U.S. subsidiary acts as the plan sponsor may not insulate the arrangement from Section 457A. Multinational organizations that have cross-charging or intercompany reimbursement arrangements for compensation costs, in particular, may be affected by this further guidance.

### What Is "Nonqualified Deferred Compensation"?

For purposes of Section 457A, "deferred compensation" and "nonqualified deferred compensation plan" generally have the same expansive meanings as those terms have under Section 409A, with certain significant exceptions. The following generally would not be considered "nonqualified deferred compensation":

- Equity interests, including profits interests, in a partnership;

- Stock options (both statutory and nonstatutory) granted at fair market value; and
- Payments made within the short-term deferral period (described below).

The following arrangements would be considered “nonqualified deferred compensation”:

- Cash settled stock appreciation rights (note that this represents a significant difference from Section 409A); and
- Hedge fund side pocket arrangements, which typically involve paying performance fees upon the disposition of illiquid securities of a fund if not structured as a profits interest in a partnership.

Notice 2009-8 provides that deferred compensation also includes earnings, both actual and notional, attributable to deferred compensation.

## What Is a Substantial Risk of Forfeiture?

If Section 457A applies to an arrangement, compensation must be included in gross income when it is no longer subject to a substantial risk of forfeiture, even if the amount is paid at a later date. A person’s right to compensation under Section 457A is subject to a “substantial risk of forfeiture” only if the compensation is conditioned upon the future performance of substantial services. This definition of substantial risk of forfeiture is narrower than that used under Section 409A or Section 83. In particular, compensation conditioned upon the achievement of performance goals may constitute a substantial risk of forfeiture under Section 409A, but this condition would not constitute a substantial risk of forfeiture under Section 457A.

## When Is Compensation Includible in Gross Income for Purposes of Section 457A?

As stated above, Section 457A provides that compensation must be included in gross income when it is no longer subject to a substantial risk of forfeiture.

However, the general rule does not apply if the amount of compensation is not yet determinable when it is no longer subject to a substantial risk of forfeiture, in which case the amount would be subject to additional taxes and penalties when it becomes determinable, as discussed below.

Earnings on deferred compensation will also be taxed when the right to the earnings is no longer subject to a substantial risk of forfeiture, provided that the earnings are reasonable and are credited at least annually. If, however, the earnings on deferred compensation are unreasonable, or are not credited at least annually, then some or all of the earnings will be subject to inclusion in income based on the principles set forth in the regulations under Section 409A.

Notice 2009-8 clarifies that if a deferred amount is included in income under Section 457A before it is paid to the service provider, then the service provider will not have to include the amount in income when the amount is actually received. If the right to an amount previously included in income under Section 457A is forfeited or otherwise permanently lost, the service provider is entitled to claim a loss determined using the rules under Section 409A.

## Is There a Penalty if the Amount of Compensation Cannot Be Determined When the Substantial Risk of Forfeiture Lapses?

If the amount of compensation is determined based on a formula (e.g., a percentage of net income for a particular period) and is not determinable at the time the substantial risk of forfeiture lapses, then the compensation is taxable when the amount becomes determinable. However, in this case, the amount is subject to an additional 20% tax, as well as an interest charge at the statutory underpayment rate plus 1%. For example, a service provider’s receipt on January 11, 2020 of a right to a payment of one percent of the service recipient’s net profits for the years 2020, 2021, and 2022, payable on the later of January 1, 2024 or the service provider’s separation from service, would be subject to

the additional 20% tax and interest charge when the amount became determinable. Thus, nonqualified entities will want to structure their compensation arrangements to avoid the situation where an unpaid amount is not determinable at the time a substantial risk of forfeiture lapses or where the amount is not subject to a substantial risk of forfeiture.

### What Is the Short Term Deferral Rule Under Section 457A?

As noted above, compensation is not subject to Section 457A if it qualifies for the short-term deferral exception. The short-term deferral exception under Section 457A exempts from the definition of deferred compensation amounts that are paid no later than 12 months after the end of the service provider's taxable year during which the right to receive the amount is no longer subject to a substantial risk of forfeiture. In addition, an amount that qualifies as a short-term deferral under Section 409A (the payment is made on the later of the 15<sup>th</sup> 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 15<sup>th</sup> 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), applied using the definition of substantial risk of forfeiture applicable to Section 457A, does not constitute deferred compensation.

The short-term deferral rule under Section 457A appears to be applied based on when a deferred amount is actually paid. Because a short-term deferral will exist as long as the deferred amount is, in fact, paid no later than 12 months after the end of the service provider's taxable year during which the right to receive the amount is no longer subject to a substantial risk of forfeiture, it may not be possible to determine whether the amount will qualify for the short-term deferral exemption at the time the substantial risk of forfeiture lapses.

### What Is the Effective Date and Grandfather Rule?

Section 457A applies to deferred amounts that are attributable to services performed after December 31, 2008. Deferred amounts attributable to services performed prior to January 1, 2009 will not be subject to Section 457A provided they are included in income in the later of (i) the last taxable year beginning before January 1, 2018 or (ii) the first taxable year in which the amounts are no longer subject to a substantial risk of forfeiture.

Notice 2009-8 sets forth general rules for determining the service period to which compensation should be attributed.

- If, according to the terms of the plan as of December 31, 2008, the compensation relates to a specific period of service, the compensation is attributable to that specific period.
- If the compensation is not attributable to a particular period, then the compensation is attributable to services performed during the year in which the employee obtains a legally binding right to the compensation.
- To the extent that the plan's terms as of December 31, 2008 condition the right to receive compensation on the performance of substantial future services, then the compensation is attributed on a pro rata basis over the period of time during which the employee is required to perform the services.

For example, assume that on January 1, 2006, an employee obtains a legally binding right to receive an amount on December 31, 2014, provided the employee continues to be employed on December 31, 2010. Under Section 457A, the compensation is attributed on a pro rata basis to services performed during 2006, 2007, 2008, 2009, and 2010, which is the period during which the employee is required to perform substantial services. Under this example, 60% of the compensation (or compensation for three out of the five years) is

attributable to services performed prior to January 1, 2009, and would, therefore, not be subject to Section 457A.

Notice 2009-8 provides a limited transition rule for deferred compensation arrangements in place as of December 31, 2008. Under the transition rule, the plan may be amended retroactively to treat an ongoing substantial risk of forfeiture as having lapsed effective prior to January 1, 2009, provided that the amendment is made in writing and is effective before July 1, 2009. In addition, the amendment must be applied consistently to every service provider covered by the arrangement or a substantially similar arrangement. This amendment would have the effect of attributing the deferred compensation to services rendered prior to January 1, 2009 and provides a means to avoid inclusion in income prior to actual payment. However, this rule may have limited utility for large multinational organizations with broad-based deferred compensation arrangements because vesting would need to be accelerated for all service providers who participate in the arrangements worldwide, not only those U.S. taxpayers who may be affected by Section 457A.

## What Should Potentially Affected Entities Do Now?

Entities or partnerships with non-U.S. or tax-exempt partners that have service providers subject to U.S. federal income tax should determine whether they are or are likely to be considered “nonqualified entities” and, if so, should examine their compensation arrangements to determine if any of them would be considered “deferred compensation” for purposes of Section 457A.

If Section 457A applies, the entity should consider taking advantage of the limited relief – available until July 1, 2009 – that permits the entity to treat a substantial risk of forfeiture as having lapsed prior to January 1, 2009.

Nonqualified entities should further consider revising their nonqualified deferred compensation arrangements so that amounts are determinable at the time the compensation is no longer subject to a substantial risk of forfeiture, to avoid subjecting service providers to an additional 20% tax and interest under Section 457A.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

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