NEW GUIDANCE ON §457A RULES FOR COMPENSATION PAYABLE BY PARTNERSHIPS AND NON-U.S. CORPORATIONS: IRS CONFIRMS IT WASN'T A BAD DREAM

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To Our Clients and Friends:

On January 8, 2009, the IRS issued Notice 2009-8 providing interim guidance on how it intends to apply the new Section 457A of the Internal Revenue Code. As reported in our Client Update of October 6, 2008, Section 457A provides that deferred compensation that is payable to U.S. taxpayers by so-called "nonqualified entities" is generally taxable when the compensation is no longer subject to a "substantial risk of forfeiture." If the amount of compensation is not "determinable" at that time, it is instead taxable when the amount becomes "determinable" *and* the amount is subject to an additional 20% tax as well as an interest charge. This new provision applies even if the deferred compensation arrangement complies with the stringent deferred compensation rules under Section 409A.

The interim guidance confirms that Section 457A may apply to (i) traditional deferred compensation arrangements payable to U.S. taxpayers by certain foreign corporations, (ii) traditional deferred compensation arrangements payable to U.S. taxpayers by operating partnerships owned by private equity funds and by non-U.S. portfolio companies owned by private equity funds, and (iii) performance fees payable by private equity funds in cases where the arrangement is structured as a fee, as is done by certain institutional funds with a corporate general partner and by certain hedge funds.

"DEFERRED COMPENSATION" DEFINED

The Notice defines "deferred compensation" and "nonqualified deferred compensation plan" for purposes of Section 457A in generally the same broad manner as under Section 409A, including most of the same exemptions. Thus, deferred compensation may encompass any legally binding right in one year to compensation payable in a future year, unless a relevant exemption applies. As with Section 409A, a profits interest in a partnership is not subject to Section 457A.

No exception for accrual basis taxpayers. The Notice confirms that, unlike under Section 409A, accrual basis taxpayers are not exempt from Section 457A's application. Accordingly, accrual basis taxpayers that provide management services to "nonqualified entities" will have to be concerned about Section 457A's application to their deferred compensation arrangements.

SARs exception very limited. Unlike Section 409A, stock appreciation rights are subject to Section 457A unless the stock appreciation rights by their terms must be (and actually are) settled in service recipient stock (and which otherwise meet the requirements for the Section 409A exemption). Stock options which are exempt from Section 409A are also exempt from Section 457A.

Short-term deferral exceptions. Section 457A has a short-term deferral exception. This exception applies if the compensation is paid no later than 12 months after the end of the service recipient's taxable year during which the compensation no longer is subject to a "substantial risk of forfeiture." For this purpose, the service recipient is the person to whom the services are directly provided at the time the "substantial risk of forfeiture" lapses. The Notice adds that the short-term deferral exception under Section 409A applies for Section 457A purposes as well. Under this exception, amounts that are required to be paid, and are paid, within 2 ½ months of the end of the service provider's taxable year in which the compensation ceases to be subject to a "substantial risk of forfeiture" is not considered deferred compensation. For example, if a calendar year service provider becomes fully vested on compensation on January 1, 2010, the compensation will not be treated as deferred compensation subject to Section 457A (or Section 409A) if it is payable and in fact paid on or prior to March 15, 2011, even if the service recipient has a fiscal taxable year ending on January 31, 2010.

"Substantial risk of forfeiture" definition significantly limited. For <u>all</u> purposes under Section 457A (including for purposes of applying the Section 409A short-term deferral exception), compensation is subject to a substantial risk of forfeiture, and therefore not required to be included in income, only so long as the service provider's right to the compensation is conditioned upon the future performance of substantial services by the service provider. Conditions to payment based on refraining from services, or achievement of any performance criteria, are disregarded. In addition, adding or extending a risk of forfeiture after the legally binding right to the compensation arises is generally disregarded.

Compensation deductible against Taxable ECI. Section 457A does not apply to compensation payable by a non-U.S. corporation if the corporation would be allowed to deduct the compensation against its Taxable ECI (defined below) had the compensation been paid in cash on the date it is no longer subject to a substantial risk of forfeiture.

TIMING OF INCOME INCLUSION

Under Section 457A, nonqualified deferred compensation payable by a nonqualified entity is generally includable in income in the year in which the amount is no longer subject to a substantial risk of forfeiture (as defined in Section 457A). Additional amounts may be includible for *each* year that the payor is (or becomes) a nonqualified entity and the vested deferred compensation remains outstanding.

If an amount is not "determinable" when it is otherwise supposed to be included in income under Section 457A, it is instead includible in income when it becomes "determinable." In this event, the additional Section 457A taxes (*i.e.*, an additional 20% income tax and an additional "premium interest" tax) apply. For this purpose, an amount is considered not "determinable" *only* if the amount is based on factors that remain variable at year's end (such as future profits). However, the Notice explains that if the information necessary to calculate a deferred amount exists, such as for a bonus based on profits from a taxable year that has ended, the amount is considered determinable, even if the necessary information is not readily available.

WHAT IS A "NONQUALIFIED ENTITY"?

For purposes of determining whether a nonqualified entity has deferred compensation, the relevant entity is the entity entitled to the compensation deduction under U.S. tax rules (*e.g.*, the employer), regardless of which entity grants or pays the compensation. Any non-U.S. corporation and any partnership (whether U.S. or non-U.S.) is potentially treated as a nonqualified entity.

Non-U.S. corporations. A non-U.S. corporation is generally a nonqualified entity unless (i) at least 80% of the corporation's gross income for the year is "effectively connected with the conduct of a trade or business in the United States" (*i.e.*, 80% of its income consists of U.S. business income that is actually taxable by the United States) ("Taxable ECI") or (ii) substantially all of its income is subject to a comprehensive foreign income tax (that is, it meets a comprehensive foreign income tax test).

A non-U.S. corporation will generally meet the comprehensive foreign income tax test if (among other things), (i) it is eligible for the benefits of a comprehensive income tax treaty between its country of residence and the United States (other than Bermuda and the Netherlands Antilles), taking into account any limitation of benefits (*i.e.*, treaty shopping) provision of the tax treaty and (ii) the amount of its "non-resident source income" (such as dividends from subsidiaries incorporated in other jurisdictions) in the year that is "excluded" from tax under the laws of its country of residence does not exceed 20% of its "gross income" for that year. However, dividends are not treated as bad income for purposes of the 20% test to the extent they are received from a U.S. corporation or from a non-U.S. corporation that itself meets the comprehensive foreign income tax test.

A non-U.S. corporation that is not eligible for the benefits of a comprehensive income tax treaty with the United States can still avoid being a "nonqualified entity" if (among other things) (i) it is able to demonstrate to the satisfaction of the Treasury Secretary that it is a resident for tax purposes in a foreign country that has a comprehensive income tax and (ii) it satisfies the 20% test described above. The Notice does not provide any guidance as to how to demonstrate comprehensive tax status to the Treasury Secretary.

Partnerships. A partnership (whether U.S. or non-U.S.) will be treated as a nonqualified entity unless 80% or more of its gross income is allocated to "eligible persons." In general, gross income will be treated as allocated to an eligible person to the extent such income is allocable (directly or through one or more tiered partnerships) to (i) a U.S. individual or corporation (and certain other U.S. taxpayers), (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 UBTI rules (note that state pension plans generally take the position that they are not subject to the UBTI rules), (iii) a non-U.S. person to the extent such gross income represents Taxable ECI or (iv) a non-U.S. person who is actually subject to a comprehensive foreign income tax with respect to such gross income (determined under principles similar to those discussed above but without regard to the 20% test). If an entity is treated as a partnership for U.S. tax purposes but is treated as a corporation for purposes of a non-U.S. jurisdiction, it appears that its gross income will also be treated as having been allocated to an "eligible person" to the extent the partnership is subject to a comprehensive foreign income tax on its income.

EFFECTIVE DATES

Section 457A generally applies to deferred amounts which are "attributable" to services performed after December 31, 2008.

Deferred amounts which are "attributable" to services performed before January 1, 2009, are not subject to Section 457A *provided* that the amounts are included in income no later than (i) the last taxable year beginning before 2018 or (ii) if later, the taxable year in which the amount is no longer subject to a substantial risk of forfeiture. The IRS guidance provides formulas for allocating compensation where amounts are attributable to services both before January 1, 2009, and after December 31, 2008. In principal, if continued service after December 31, 2008, is a condition to payment, the arrangement is allocated between the pre-2009 service and post-2008 service based on the vesting period. For purposes of applying this allocation, only the plan's terms as in effect on December 31, 2008, are included, with one important exception. A plan may be amended no later than July 1, 2009, to provide that an ongoing substantial risk of forfeiture is deemed to have lapsed before 2009, thereby allowing for attribution of the entire deferred compensation arrangement to pre-2009 services.

COORDINATION WITH SECTION 409A AND RELATED TRANSITION RELIEF

The IRS guidance includes transition relief permitting a change in the time and form of payment of amounts attributable to services performed prior to January 1, 2009 (including Section 409A grandfathered amounts) to conform the date of distribution to the date the

amount may be required to be included in income under Section 457A's transition period, provided that it is agreed in writing prior to December 31, 2011.

Until further guidance, an inclusion in income under Section 457A is treated as a payment for purposes of the short-term deferral rule under Section 409A (and will not be an improper acceleration for Section 409A purposes). Accordingly, until further guidance is issued, an amount that is subject to Section 457A would not also be subject to Section 409A (although it is not clear how Section 457A and Section 409A would apply with respect to amounts that are not "determinable").

WHAT YOU SHOULD BE DOING NOW

Non-U.S. companies, partnerships (whether U.S. or non-U.S.) and managers that pay or receive deferred compensation should determine whether they are likely to be considered a "nonqualified entity" (or are receiving deferred compensation as to which Section 457A applies). If so, they should begin the process of identifying arrangements that may be covered by Section 457A and determining what changes, if any, may be necessary or desirable to avoid the Section 457A penalties.

This memorandum was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax law.

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