GROOM LAW GROUP

MEMORANDUM TO CLIENTS

February 3, 2009

RE: IRS Guidance on Section 457A Foreign Deferred Compensation Rules

New Code section 457A, which imposes substantial restrictions on the use of nonqualified deferred compensation arrangements sponsored by certain foreign entities, was included as part of the financial bailout legislation (Pub. L. No. 110-343) enacted last fall. The Congressional impetus for these complex new rules was to raise revenue and target offshore deferral arrangements for hedge fund managers. Under the new provision, compensation deferred under a nonqualified plan of certain nonqualified foreign entities is taxed at the time of vesting – i.e., the deferred amounts are includable in income when such amounts are no longer subject to a "substantial risk of forfeiture" – even if they are not yet payable.

The Treasury Department and Internal Revenue Service recently released Notice 2009-8 (the "Notice," Jan. 26 IRS Bulletin), which provides interim guidance interpreting Code section 457A. In general, it appears that the Notice confirms our fears that Code section 457A will impact a broad range of employers, employees and compensation arrangements. For example, the Notice confirms that the definition of "nonqualified deferred compensation" under Code section 457A is broader than the definition under section 409A (e.g., in the case of cash-settled SARs and performance-based compensation). In addition, it appears that the guidance in the Notice on whether a foreign corporation is a "nonqualified entity" could result in the application of the section 457A rules even where the foreign corporation is resident in a country where the U.S. has entered into a comprehensive income tax treaty (e.g., a country with a territorial tax system).

Set forth below is a summary of the major issues addressed in the Notice.

A. Application of Code Section 457A to Nonqualified Entities

Code section 457A applies to deferrals under a nonqualified plan maintained by a nonqualified entity, which is defined as (1) any foreign corporation unless substantially all of its income is (a) effectively connected with a U.S. trade or business, or (b) subject to a "comprehensive foreign income tax," and (2) any partnership, unless substantially all of its income is allocated to persons other than (a) foreign persons with respect to whom the income is not subject to a comprehensive foreign income tax, and (b) organizations which are tax-exempt.

Timing of Determination; Plan Sponsor – The Notice provides generally 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 the deferred compensation is no longer subject to a substantial risk of forfeiture. The Notice explains how section 457A may apply to deferred amounts in some years, but not others (e.g., depending upon whether the sponsor is a nonqualified entity as of the last day of the year).

Under the Notice, the sponsor of a plan is any entity or entities that would be entitled to a compensation deduction under U.S. federal income tax principles if the entity paid the deferred amount to the service provider in cash in the relevant tax year. Importantly, the typical application of this definition would appear to exclude a foreign corporation with a U.S. affiliate as to the U.S. affiliate's service providers.

Application to Foreign Corporations – The Notice provides extensive guidance regarding whether substantially all of the income of a foreign corporation is effectively connected with a U.S. trade or business or subject to a comprehensive foreign income tax. Under the Notice, substantially all of a foreign corporation's income is effectively connected with a U.S. trade or business if at least 80 percent of the corporation's gross income is effectively connected to the conduct of a trade or business in the U.S. under Code section 882 that is not exempt from U.S. federal income tax pursuant to a treaty obligation of the U.S. (e.g., because the income is not attributable to a "permanent establishment").

In general, substantially all of the income of a foreign corporation is subject to a comprehensive foreign income tax if (1) either (a) the foreign corporation is "eligible" (as provided under guidance in the Notice) for the benefits of a comprehensive income tax treaty in effect on January 26, 2009, between its country of residence and the U.S. (except for treaties with Bermuda and Netherlands Antilles), or (b) the foreign corporation demonstrates to the satisfaction of Treasury and the Service that it is resident for tax purposes in a foreign country that has a comprehensive foreign income tax, and (2) the foreign corporation is not taxed by its country of residence under any regime or arrangement that is materially more favorable than the corporate income tax otherwise imposed by such country.

Even if this test is satisfied, however, the Notice takes the position that substantially all of the foreign corporation's income will not be treated as subject to a comprehensive foreign income tax if (1) the foreign corporation's taxable income as determined under the tax laws of its country of residence excludes, in whole or part, "nonresidence source income" realized by the foreign corporation, and (2) the aggregate amount of "nonresidence source income" excluded for the tax year exceeds 20 percent of the foreign corporation's gross income. An item of nonresidence source income is considered excluded under the laws of its country of residence if, among other things, the foreign corporation's income excludes such amount by means of an exemption, exclusion, deduction (including a dividends received deduction), or by means of taxation at a tax rate of less than 50 percent of the generally applicable rate. The Notice provides special rules in the case of a foreign corporation with income effectively connected with the conduct of a U.S. trade or business that is taxable under Code section 882, and with respect to dividends from a domestic corporation or a corporation with substantially all of its income that is subject to a comprehensive foreign income tax.

We understand that this exception for excluded nonresidence source income could result in the broad application of section 457A, even in instances where a foreign corporation is resident in a country where the U.S. has entered into a comprehensive income tax treaty. In particular, we understand that this provision could have a significant effect on the application of section 457A to foreign corporations that are residents of countries with territorial tax regimes.

Application to Partnerships – The Notice also provides detailed guidance regarding whether substantially all of a partnership's income is allocated to persons other than (a) foreign persons with respect to whom the income is not subject to a comprehensive foreign income tax, and (b) organizations which are tax-exempt under the U.S. tax laws. Very generally, the Notice provides that a partnership that is the sponsor of the nonqualified deferred compensation plan is not a nonqualified entity if at least 80 percent of its gross income is allocated to "eligible persons" (i.e., not a tax-exempt or foreign person with income not subject to a comprehensive foreign income tax).

"Service Provider" Definition – The Notice provides that a service provider subject to section 457A may include, among other things, an individual, corporation, subchapter S corporation, partnership, personal service corporation, and a qualified personal service corporation. The Notice also provides that the application of section 457A does not vary depending on whether the service provider is a cash basis or accrual basis taxpayer. The Notice does, however, include an exception for an independent contractor that is exempt from section 409A because the independent contractor performs services for multiple, unrelated clients.

B. Expanded Definition of "Nonqualified Deferred Compensation"

The Notice confirms that the term "nonqualified deferred compensation plan" under Code section 457A generally has the same meaning as under Code section 409A – but with exceptions that apply these restrictive new rules to several forms of compensation that are generally excluded from the application of Code section 409A.

Certain Equity Compensation – Under Code section 457A, the definition of "nonqualified deferred compensation plan" specifically includes amounts that are "based on the appreciation in value of a specified number of equity units." The Notice confirms that section 457A generally applies to stock appreciation rights ("SARs"), including SARs issued at fair market value that are exempt from section 409A. Surprisingly, however, the Notice then provides an exemption from section 457A for SARs that are exempt from section 409A and that must be settled in service recipient stock. The Notice also provides an exemption from section 457A for fair market value, nonstatutory stock options that are exempt from section 409A (i.e., "garden variety" nonqualified options).

The Notice does not address the possible application of Code section 457A to either restricted stock or restricted stock units ("RSUs"). Restricted stock is generally exempt from Code section 409A since these awards are subject to taxation under Code section 83. A Joint Committee on Taxation ("JCT") staff description of an earlier version of the legislation had provided that section 457A was not intended to apply to transfers of property under Code section 83, which would also include such awards.

Application of Short-Term Deferral Exception – One of the most useful exceptions from section 409A is for amounts that are considered "short-term deferrals" distributed within the first 2 ½ months of the year after the year in which the amounts are no longer subject to a substantial risk of forfeiture. The Notice explains how section 457A makes changes to both the definition of "substantial risk of forfeiture," and to the short-term deferral period during which payment must be made to qualify for the exception.

Consistent with statements in the JCT Technical Explanation of the earlier version of the legislation, the Notice provides that rights to compensation are not subject to a substantial risk of forfeiture merely because such rights are subject to the occurrence of a condition related to the purpose of the compensation. Thus, Code section 457A does not recognize conditions based on the satisfaction of objective performance criteria, as permitted under the Code section 409A and 83 regulations. Instead, the Notice provides that compensation is subject to a substantial risk of forfeiture under section 457A only if the right to the compensation is conditioned on the future performance of substantial services.

On the plus side, the Notice extends the short-term deferral payment period to the 12-month period after the end of the service recipient's taxable year during which the right to the payment is no longer subject to a substantial risk of forfeiture. The Notice provides that the "service recipient" for this purpose is the person for whom the service provider is directly providing services at the time of vesting. In addition, the Notice provides an exemption from section 457A for payments that would qualify for the section 409A short-term deferral exception (i.e., made no later than the 2 ½-month period after the service recipient's or service provider's year in which vesting occurred) but using the section 457A tighter definition of substantial risk of forfeiture.

C. Calculation of Inclusion Amounts

The amount that is required to be included in income under section 457A is determined under the rules of Code section 409A. The IRS recently released proposed regulations on the calculation of these amounts (Prop. Treas. Reg. § 1.409A-4)

The Notice provides that if an amount is included in income before the amount is paid to the service provider (1) the amount is not again includible in income when the amount is paid to the service provider (i.e., the service provider gets "basis"), and (2) if the amount is ultimately forfeited, the service provider may be able to claim a deduction for the loss under the proposed section 409A inclusion regulations. In general, the right to earnings credited at least annually is includible in income when such right is no longer subject to a substantial risk of forfeiture.

If the amount of deferred compensation is "not determinable" at the time the compensation is otherwise includible in income under section 457A, it is includible in income in the year it becomes determinable, and the tax imposed that year is increased by a 20 percent additional tax and a premium interest tax. The Notice provides generally that a deferred amount will be treated as not determinable if the deferred amount would be subject to the "formula amount" rules in the proposed section 409A inclusion regulations. Under those rules, an amount payable in the future under a plan that is not an account balance plan is a formula amount to the extent the amount is dependent upon variable factors that are not determinable after applying the assumptions and rules in the proposed regulations. The Notice also includes an example that confirms that bonus and other performance-based arrangements could be subject to these additional tax amounts for "not determinable" amounts.

D. Effective Date

Code section 457A is generally effective for amounts deferred that are attributable to services performed after 2008. However, amounts attributable to services before 2009 are includible in income no later than 2017. Thus, for example, supplemental pension benefits attributable to pre-2009 service will be taxed in 2017 if they have not vested yet and do not vest in any year before 2017. The Notice contains guidance for determining the periods of service to which deferred compensation is attributable for purposes of these rules. In general, these rules key off of the plan's terms as of December 31, 2008. However, the Notice permits the plan to be amended prior to July 1, 2009 to retroactively provide for the vesting of amounts before 2009, so long as the amendment is applied consistently to every service provider participating in the same or a substantially similar arrangement.

E. Coordination with Section 409A

The Notice provides that the inclusion in income under section 457A is treated as a payment under section 409A. The Notice also indicates that an amount that is not subject to section 457A because it qualifies as a short-term deferral under the section 457A rules remains subject to the requirements of section 409A unless the arrangement also qualifies as a short-term deferral under the section 409A rules.

As directed by the statute, the Notice includes transition rules under which a plan may be amended before 2012 with respect to amounts attributable to services performed before 2009 to change the time and form of payment to conform to the date of income inclusion under section 457A without violating the section 409A anti-acceleration rules or being a material modification of pre-2005 amounts grandfathered from section 409A. In addition, the Notice provides transition rules to address situations in which deferred amounts become subject to section 457A in a year when the amounts are no longer subject to a substantial risk of forfeiture and thus the amounts do not qualify for the section 409A short-term deferral exception. To address these situations, the Notice provides that, until further guidance, the payment of a deferred amount in the year the amount is includible in income under section 457A does not constitute an impermissible acceleration under section 409A.

The Notice states that Treasury and the IRS anticipate issuing additional guidance and request comments on the issues addressed in the guidance and certain other issues.

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