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Guidance and Relief for Deferred Compensation Arrangements of Certain Foreign Corporations and Partnerships

The Internal Revenue Service has issued interim guidance on deferred compensation paid to U.S. taxpayers by certain foreign corporations and partnerships considered to be “tax-indifferent entities.” Internal Revenue Code (“Code”) Section 457A (“457A”) imposes a 20% additional tax and interest on compensation paid by these entities that is not taxable within one year after it is “earned.” While 457A was drafted to target offshore hedge fund deferral arrangements, the interim guidance contained in Notice 2009-8 confirms that its scope is much broader and potentially can reach deferred compensation arrangements maintained by a wide range of foreign corporations and partnerships. Each foreign corporation (including a foreign subsidiary of a U.S. entity) or a partnership (both domestic and foreign) that receives services from a U.S. taxpayer should consider whether it is a “nonqualified entity” under 457A and, if so, whether it has any “nonqualified deferred compensation plans” with any service providers that are U.S. taxpayers. Furthermore, each service provider that is a U.S. taxpayer that benefits under such plans should seek counsel and consider the impact of 457A.

457A basically provides that deferred compensation from a “nonqualified entity” will be includable in a U.S. taxpayer’s gross income at the time that compensation is no longer subject to a substantial risk of forfeiture. Notice 2009-8 provides guidance and transitional relief on: (1) the types of arrangements that are considered “nonqualified deferred compensation” subject to 457A; (2) the rules for identifying the plan sponsor of a nonqualified deferred compensation plan, and determining whether the sponsor is a “nonqualified entity”; (3) what constitutes a “substantial risk of forfeiture” for purposes of 457A; (4) the rules for allocating deferred compensation to the year(s) in which the services are performed; and (5) the rules for coordinating the application of 457A with Code Section 409A.

Identification of Nonqualified Deferred Compensation Plans and Nonqualified Entities

Each foreign employer or other service recipient (including a U.S. employer operating through non-U.S. affiliates and a foreign or domestic partnership with partners that are exempt organizations or foreign partners) that has a compensation arrangement with a service provider who is subject to U.S. tax should determine whether it is a “nonqualified entity,” and identify any contracts, agreements, programs, or any other plans that may be subject to 457A.

Notice 2009-8 defines the term “nonqualified deferred compensation” in the same manner as Section 409A, but includes equity appreciation rights that are not settled in service recipient equity (which are ordinarily exempt under Section 409A). Under Notice 2009-8, the “sponsor” of the nonqualified deferred compensation plan is determined by reference to whether, if the entity paid the amount deferred in cash in a year in which the entity is a “nonqualified entity”, it would be entitled to a compensation deduction under U.S. federal income tax principles.

Under 457A, the term “nonqualified entity” means: (a) any foreign corporation, unless substantially all of its income is (i) “effectively connected” (see below) with the conduct of a trade or business in the United States, or (ii) subject to a comprehensive foreign income tax; and (b) any partnership (foreign or domestic), unless substantially all of its income is allocated to persons other than (i) foreign persons not subject to a comprehensive foreign income tax on

that income, and (ii) organizations which are exempt from tax under the Code. Notice 2009-8 also establishes rules for determining when a foreign corporation is subject to a “comprehensive foreign income tax,” and when a partnership’s income is allocated to eligible persons” (see below), including rules for determining allocations in the context of tiered ownership structures.

Foreign Corporation. A foreign corporation’s income is “effectively connected” if at least 80% of its gross income is effectively connected with the conduct of a trade of business in the United States, and the income is not exempt from U.S. income tax under a treaty with the United States. In general, a foreign corporation is considered subject to a “comprehensive foreign income tax” if it (i) is eligible for the benefits of a comprehensive income tax between its country of residence (other than Bermuda and the Netherlands Antilles) and the United States, or demonstrates to the Treasury Secretary that it resides in a foreign country that has a comprehensive income tax, and (ii) is not taxed by its country of residence under a materially more favorable corporate income tax than is otherwise generally imposed by that country. However, even if both of the foregoing tests are satisfied, a foreign corporation may not be subject to a comprehensive foreign income tax for 457A purposes if certain other conditions are not met.

Partnerships. A partnership (foreign or domestic) is treated as a “nonqualified entity” unless 80% or more of its income is allocated (or deemed allocated) to “eligible persons.” A partnership’s income is so allocated to “eligible persons” if it is allocated to: (i) a U.S. taxpayer; (ii) a U.S. tax exempt entity, provided the income is derived in an “unrelated trade or business” and is taxable under the unrelated business taxable income rules; (iii) a foreign person, so long as the income represents effectively connected income not exempt from U.S. tax under a U.S. income tax treaty; or (iv) a foreign person who is subject to a comprehensive foreign income tax on the income.

Under Notice 2009-8, 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 vests and remains deferred. Under this rule, a plan’s sponsor status as a nonqualified entity can occur at any time in a year and may change from year to year. For a partnership, this determination is based on the allocations (or deemed allocations) of gross income for the partnership’s taxable year ending with or within the service provider’s taxable year. If a partnership does not have a taxable year that has ended or ends on the last day of the service provider’s taxable year, a reasonable, good faith estimate of the allocation (or deemed allocation) for the partnership’s current taxable year must be used to determine if it is a nonqualified entity. As a result, deferred compensation arrangements may move in or out of 457A coverage.

457A deferred compensation is includable in gross income when it is no longer subject to a “substantial risk of forfeiture” (*i.e.*, when the right to the income becomes vested). In a departure from the rules under Section 409A, only future performance of substantial services is treated under 457A as a substantial risk of forfeiture. In addition, as under Section 409A, the addition or extension of any risk of forfeiture after the right to compensation becomes vested is disregarded unless the amount paid is materially greater the amount that would have been paid before the addition or extension.

Compensation payable in the future that currently is “not determinable,” will be included in income when it becomes determinable, at which time the additional 20% tax and interest will apply. Thus, under 457A the additional tax and interest apply to compensation subject to performance criteria or factors that remain variable, including gains or losses on “side-pocket” arrangements (where incentive fees are based on the realized profits from the side-pocket investment).

Effective Dates and Transition Guidance

457A generally applies to deferred amounts attributable to services performed after December 31, 2008. Amounts attributable to services performed before January 1, 2009 must be included in income on the later of (i) the last taxable year beginning before 2018, or (ii) the taxable year in which the deferred amount is no longer subject to a substantial risk of forfeiture. For services performed after December 31, 2008, 457A provides a short-term deferral exception if the deferred compensation is paid no later than 12 months following the service recipient's taxable year in which the deferred compensation vested. However, any plan or agreement that wishes to use the short-term deferral must be amended to comply with the 457A rule.

Notice 2009-8 provides plan sponsors with the following transition relief: (a) a one-time opportunity to amend the plan in writing to accelerate the vesting of deferred compensation retroactive to December 31, 2008, so long as the amendment is adopted before July 1, 2009 and is consistently applied to every service provider in the same or substantially similar arrangement, and (b) for deferred compensation attributable to services performed before January 1, 2009 that may be required to be included in income under 457A, the ability to change the time and form of payment at any time prior to December 31, 2011 to conform to the date the deferred compensation becomes taxable under 457A. These changes will not be treated as violations of Section 409A and will not cause the loss of grandfathering from Section 409A.

If you have any questions regarding the foregoing, please contact one of the attorneys listed below.

[John M. Collins](#)
(214) 651-5564

john.collins@haynesboone.com

[Taylor H. Wilson](#)
(214) 651-5615

taylor.wilson@haynesboone.com

[Vicki Martin-Odette](#)
(214) 651-5674

vicki.martin-odette@haynesboone.com

[Charles F. Plenge](#)
(214) 651-5573

charles.plenge@haynesboone.com

[Greta E. Cowart](#)
(214) 651-5592

greta.cowart@haynesboone.com

[Jesse J. Gelsomini](#)
(713) 547-2233

jesse.gelsomini@haynesboone.com

[Susan A. Wetzel](#)
(214) 651-5389

susan.wetzel@haynesboone.com

[Marilyn Doolittle](#)
(713) 547-2901

marilyn.doolittle@haynesboone.com

[James Williamson](#)
(214) 651-5224

james.williamson@haynesboone.com

[Christina Markell-Balleza](#)
(214) 651-5486

christina.markell-balleza@haynesboone.com

[Chris Kang](#)
(214) 651-5944

chris.kang@haynesboone.com