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Client Alert

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June 2009

Internal Revenue Service Issues Interim Guidance under Code Section 457A

In January 2009, the Internal Revenue Service (the "IRS") issued Notice 2009-8 to provide interim guidance on the application of Section 457A of the Internal Revenue Code of 1986, as amended (the "Code"), which was enacted on October 3, 2008 as part of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008. Code Section 457A generally provides that any compensation that is deferred under a nonqualified deferred compensation plan of a nonqualified entity, defined as certain tax-indifferent corporations and partnerships, is includible in gross income when there is no substantial risk of forfeiture of the rights to such compensation. In addition, if the amount of such compensation is "not determinable" (as described below) at the time that such compensation is required to be includible in income under Code Section 457A, then such compensation will be includible in income when determinable and will be subject to a 20% additional penalty tax and imputed interest (at the underpayment rate plus 1%) as if such compensation had been includible in income as of the time the income was not subject to a substantial risk of forfeiture.

Code Section 457A applies in tandem with Code Section 409A, which is generally applicable to compensation that is deferred under a nonqualified deferred compensation plan, as both provisions may apply to amounts deferred under the same arrangement. The guidance under Notice 2009-8 adopts many of the definitional and operational rules of Code Section 409A, with some significant differences set forth herein.

Code Section 457A applies to amounts deferred that are attributable to services performed after December 31, 2008. In the case of amounts deferred that are attributable to services performed before January 1, 2009, a special rule applies which provides that such amounts need not be included in income until the later of (i) the last taxable year beginning before January 1, 2018, or (ii) the first taxable year in which there is no substantial risk of forfeiture of the right to the deferred amount. The IRS provided transition relief under Notice 2009-8 that allows a plan to be amended retroactively under certain circumstances so as to take advantage of such special rule by ensuring that the amounts deferred thereunder would be treated as attributable to services performed before January 1, 2009. However, any such amendment must be made in writing and effective before July 1, 2009. See below under "Effective Date" for a more detailed description of such expiring transition relief.

The following is a summary of the material requirements of Code Section 457A and Notice 2009-8, as well as certain relevant provisions of Code Section 409A and the rules and regulations thereunder.

Service Providers Covered

Service providers that may be subject to Code Section 457A include individuals, corporations, subchapter S corporations, certain personal service corporations (including noncorporate entities that would be personal service corporations if corporations) and partnerships. The Code Section 409A exclusion for independent contractors who have multiple unrelated clients (other than independent contractors that provide management services) also is available under Code Section 457A. However, unlike Code Section 409A which applies only to cash-basis taxpayers, Code Section 457A may apply to service providers regardless of whether they account for gross income from the performance of services under the cash or accrual method of accounting.

Nonqualified Deferred Compensation Plan

Code Section 457A incorporates the definition of "nonqualified deferred compensation plan" from Code Section 409A (with some modifications as described in more detail below). Such term generally includes any agreement, method, program or other arrangement (other than tax-qualified plans and plans that provide vacation leave, sick leave, compensatory time, disability pay or death benefits) that provides for a deferral of compensation if, under the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that is or may be payable to the service provider in a later taxable year. This broad definition includes traditional deferred compensation plans, as well as many other arrangements not typically viewed as providing for a deferral of compensation, such as certain severance arrangements, bonuses, equity awards, retention arrangements, and long-term incentive compensation plans, with an exception for certain partnership interest grants, as set forth below.

The term "nonqualified deferred compensation plan" also includes any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient. For purposes of both Code Sections 457A and 409A, a nonqualified deferred compensation plan does not include any stock appreciation right that is granted with an exercise price equal to the fair market value of the underlying service recipient stock on the date of grant, if the stock appreciation right is settled in service recipient stock. However, for purposes of Code Section 457A only, the term nonqualified deferred compensation includes any stock appreciation right that may be settled other than in service recipient stock (e.g., in cash), even if granted with an exercise price not less than the fair market value of the underlying service recipient stock on the date of grant (such a stock appreciation right would be excluded from coverage under Code Section 409A).

In addition, for purposes of Code Section 457A, the exception from coverage under Code Section 409A of a grant of an equity interest in a partnership (meaning a right to purchase actual equity in such entity, and not a mere right to an amount equal to the appreciation in such equity) is applicable. Until additional guidance is issued, taxpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated under applicable guidance as not resulting in inclusion of income by the service provider at the time of issuance, as also not resulting in the deferral of compensation. Issuances of capital interests in connection with the performance of services are treated in the same manner as an issuance of stock. However, payments to partners that are treated as guaranteed payments under the Code may be treated as nonqualified deferred compensation for purposes of both Code Sections 457A and 409A, unless an exception applies (*e.g.*, the short-term deferral exception).

Substantial Risk of Forfeiture. Compensation that is paid at the time the right to such compensation is no longer subject to a substantial risk of forfeiture (or within specified time periods thereafter) may not be considered nonqualified deferred compensation for purposes of Code Sections 457A and 409A. Code Section 409A provides that a substantial risk of forfeiture exists if a person's rights are conditioned upon either the future performance of substantial services by such person or the occurrence of a condition related to the purpose of the compensation if the possibility of forfeiture is substantial (*e.g.*, under certain circumstances, the attainment of a prescribed level of earnings or equity value or the completion of an initial public offering). However, Code Section 457A has a narrower definition of "substantial risk of forfeiture." For purposes of Code Section 457A, generally, the rights of a person to compensation are subject to a substantial risk of forfeiture only if the person's rights to such compensation are conditioned upon the future performance of substantial services by such person. Accordingly, under Code Section 457A, the rights of a person to compensation (including a stock right) are not subject to a substantial risk of forfeiture merely because those rights are subject to the occurrence of a condition related to a purpose of the compensation, or are conditioned, directly or indirectly, upon the refraining from the performance of services.

Code Section 457A authorizes the Treasury Department to prescribe rules that provide that if compensation is determined solely by reference to the amount of gain recognized on the disposition of an "investment asset," such compensation will be treated as subject to a substantial risk of forfeiture until the date of such disposition. An "investment asset" generally is defined as any single asset (other than an investment fund or similar entity) (i) acquired directly by an investment fund or similar entity, (ii) with respect to which such investment fund or similar entity does not participate in the active management of such asset, and (iii) substantially all of any gain on the disposition of which (other than the deferred compensation) is allocated to investors in such investment fund or similar entity. Due to the rule's single asset requirement, it is unlikely to apply to most hedge fund side pocket arrangements.

Short-Term Deferral Exception. Similar to Code Section 409A, Code Section 457A contains an exception for short-term deferrals, which excepts from coverage under Code Section 457A compensation that is paid not later than 12 months after the end of the service recipient's taxable year during which the right to the payment of the compensation is first no longer subject to a substantial risk of forfeiture. For purposes of this exception, the service recipient is the person for whom the service provider is directly providing services at the time the right to the payment is first no longer subject to a substantial risk of forfeiture. Additionally, any amount qualifying as a short-term deferral under Code Section 409A, applied using the definition of substantial risk of forfeiture

for Code Section 457A purposes, does not constitute deferred compensation for purposes of Code Section 457A. However, the Code Section 457A short-term deferral exception does not apply to compensation that is treated as subject to a substantial risk of forfeiture because it is determined solely by reference to the amount of gain recognized on the disposition of an "investment asset." Accordingly, under Code Section 457A, such "investment asset" compensation generally must be included in income in the same taxable year in which the right to such compensation is no longer subject to a substantial risk of forfeiture.

The short-term deferral exception under Code Section 409A differs from the Code Section 457A exception as it generally provides that a deferral of compensation does not occur if (i) the service provider actually or constructively receives the compensation on or before the 15th day of the third month following the end of the service provider's or the service recipient's (whichever occurs later) taxable year in which the right to such compensation is no longer subject to a substantial risk of forfeiture and (ii) the applicable plan or arrangement is either silent as to the date of payment or it provides that the payment of such compensation must be paid within such time period. Additionally, the Code Section 409A short-term deferral exception applies even if the compensation is not actually paid within the applicable short-term deferral period if the payment is unforeseeably delayed because making the payment would be administratively impracticable or would jeopardize the service recipient's ability to continue as a going concern. There appears to be no similar exception under Code Section 457A.

Nonqualified Entities

Code Section 457A applies only to "nonqualified entities," while Code Section 409A applies to a much broader group of payors. A "nonqualified entity" is:

1. any foreign corporation unless substantially all of its income is (a) effectively connected with the conduct of a trade or business in the United States, or (b) subject to a comprehensive foreign income tax; or

2. any partnership (domestic or foreign) unless substantially all of its income is allocated to persons other than (a) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and (b) tax-exempt organizations.

For both foreign corporations and partnerships, "substantially all of its income" is defined as at least 80 percent of the gross income of such entity. As described in more detail below, the determination of whether an entity is a nonqualified entity is determined annually.

Foreign Corporations. A foreign corporation's income is subject to a "comprehensive foreign income tax" if the foreign corporation (a) demonstrates to the satisfaction of the Secretary that it is resident for tax purposes in a foreign country that has a comprehensive income tax, or (b) is eligible for the benefits of a comprehensive income tax treaty between the country of residence and the United States (including satisfying the residency and limitation on benefits provisions), but excluding the tax treaties with Bermuda and the Netherland Antilles, and the foreign 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 such country. However, substantially all of the income of a foreign corporation will not be treated as subject to a comprehensive foreign income tax if the foreign corporation's residence country taxable income excludes, in whole or in part, nonresidence source income and the amount of such excluded nonresidence source income for the relevant taxable year exceeds 20 percent of the gross income of the foreign corporation. Gross income of the foreign corporation includes all income of the foreign corporation determined under the income tax laws of the residence country, plus any nonresidence source income to the extent it is not otherwise included. Nonresidence source income is considered to be excluded if it is effectively taxed at a rate that is less than 50 percent of the generally applicable rate through exclusion, exemption, deduction or otherwise. In calculating this amount, nonresidence source income does not include income that is effectively connected with a U.S. trade or business or dividends from either a U.S. corporation or a corporation substantially all of the income of which is subject to a comprehensive foreign income tax.

Partnerships. A partnership is a nonqualified entity for a taxable year unless at least 80 percent of its gross income for such taxable year is allocated to eligible persons. Generally, income is considered to be allocated to eligible persons if such income is subject to either the U.S. income tax or a comprehensive foreign income tax (see discussion above with respect to foreign corporations).

Gross income is allocated up through multiple tiers of partnerships to the partners or direct or indirect owners of partners if such persons take such income into account on a current basis under the laws of the country in which the person is resident (other than solely by reason of an anti-deferral regime, *i.e.*, through rules similar to the U.S. passive foreign investment company and controlled foreign corporation rules). If a partnership allocates income in accordance with the U.S. partnership allocation rules, allocations for purposes of Code Section 457A are such actual tax allocations. For partnerships that are not required to, or do not, comply with the U.S. allocation rules, income is allocated using any reasonable method that incorporates the U.S. principles.

Determination of Status. The determination of whether a nonqualified deferred compensation plan is a plan of a nonqualified entity (*i.e.*, whether the nonqualified entity is a "sponsor" of the plan) is made as of the last day of the service provider's relevant taxable year. For this purpose, with respect to any amount deferred under a plan, the sponsor of the plan is any entity or entities which, if the entity paid the amount deferred in cash to the service provider in the relevant taxable year, would be entitled to a compensation deduction under U.S. federal income tax principles. This provision clarifies the uncertain situation where a foreign parent company that is treated as a "nonqualified entity" sponsors a plan for the benefit of employees of its U.S. subsidiaries, as well as other entities in the parent's group. In accordance with this guidance, when such a foreign parent sponsors a plan that covers U.S. employees of its U.S. subsidiaries, the U.S. subsidiaries will be treated as the sponsor of the plan with respect to their U.S. employees, and, as a result, compensation paid to such employees will not be subject to Code Section 457A.

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 nonqualified deferred compensation is no longer subject to a substantial risk of forfeiture and remains deferred. Whether a partnership is a nonqualified entity as of the last day of the service provider's taxable year is determined based on the allocations (or deemed allocations) of gross income by the partnership for the partnership's taxable year ending with or within the service provider's taxable year. If a partnership's taxable year ends on or after the last day of the service provider's taxable year, a reasonable, good faith estimate of the allocation (or deemed allocation) of the income of the partnership for its current taxable year must be used to determine whether it is a nonqualified entity.

This annual test for partnerships could prove to be very difficult to apply in practice, especially with respect to service providers who do not have full access to the financial records of a foreign partnership. Notice 2009-8 specifies that comments are sought for alternative approaches to the timing of the determination of such status.

Amount Includible in Income

For purposes of Code Section 457A, deferred compensation includes earnings attributable to any deferred compensation that is subject to Code Section 457A, determined using Code Section 409A principles. When the right to earnings is specified under the terms of the plan, the legally binding right to earnings arises at the time of the deferral of the compensation to which the earnings relate. If an amount is included in income under Code Section 457A before the amount is paid to the service provider and, before payment, the right to the amount is forfeited, the service provider may rely upon the Code Section 409A rules to determine the availability of any loss.

Deferred Amounts That Are Not Determinable and Penalties

For purposes of Code Section 457A, the deferred amount to which a service provider is entitled is treated as "not determinable" if the deferred amount would be calculated under the general formula amount rules set forth in the proposed income inclusion regulations under Code Section 409A. Under these rules, for a plan that is not an account balance plan, an amount payable in a future taxable year is a formula amount (and thus not determinable) to the extent the amount is dependent upon factors that are not determinable as of the end of the service provider's taxable year. This generally occurs where the amount of the payment (and not the timing of the payment) is unknown at the end of the taxable year because it is based upon factors that remain variable as of the end of the taxable year. Notice 2009-8 contains an example with respect to an annual bonus that is based on annual profits as of the end of a taxable year. In this example, the deferred amount is considered a formula amount (and therefore, not determinable) at all times prior to the end of a taxable year. However, the amount would be considered determinable as of the end of the taxable year because the information necessary to calculate the bonus exists, regardless of whether the calculation of the annual profits is readily available at the end of the year.

A deferred amount that is treated as not determinable at the time it is required to be included in gross income must be included in gross income when the deferred amount becomes determinable. At such time, the formerly not determinable amount is subject to an additional penalty tax at the rate of 20% and imputed interest (at the underpayment rate plus 1%) from the time of deferral or, if later, when the deferred compensation ceases being subject to a substantial risk of forfeiture.

Under Code Section 457A, deferred compensation must be included in gross income when there is no substantial risk of forfeiture of the rights to such compensation or the amount becomes determinable (with penalties and interest). Unless the Code Section 457A short-term deferral exception applies, there is no method (without penalty) to defer income inclusion of Code Section 457A deferred compensation beyond the year in which a substantial risk of forfeiture no longer applies.

On the other hand, Code Section 409A provides numerous ways to pay deferred compensation in a year later than the year in which a substantial risk of forfeiture no longer exists that are in compliance with Code Section 409A. For example, Code Section 409A provides that deferred compensation may be paid upon a specified date or pursuant to a fixed schedule,

or upon a separation from service, change in control, death, disability or an unforeseeable emergency (as each term is defined under Code Section 409A), all of which may occur well beyond the year in which such compensation is no longer subject to a substantial risk of forfeiture.

Effective Date

As stated above, Code Section 457A applies to any amounts deferred that are attributable to services performed after December 31, 2008. In the case of any amount deferred which is attributable to services performed before January 1, 2009, such amount must be included in gross income in the later of (i) the last taxable year beginning before January 1, 2018, or (ii) the first taxable year in which there is no substantial risk of forfeiture of the right to the deferred amount.

If a service provider obtained a legally binding right to compensation under a plan on or before December 31, 2008, and as of December 31, 2008 that plan provided for benefit payments under a formula that related to a specific period of service in a year (such as relating to compensation paid during that period), the compensation is attributable to that specific period, except as otherwise provided herein. To the extent that, based on the terms of the plan as of December 31, 2008, compensation is not attributable to services performed in a particular period, then the compensation generally is attributable to services performed during the year in which the employee obtains the legally binding right to the compensation. If a service provider is entitled to compensation only upon an involuntary separation from service, the amount attributable to services performed on or before December 31, 2008 is the amount the service provider would be entitled to based upon the years of service and compensation earned as of December 31, 2008 (disregarding any requirement to perform further services). Any additional amount to which the service provider becomes entitled after December 31, 2008 due solely to additional services performed after December 31, 2008 is attributable to services performed after December 31, 2008. A right to reasonable earnings on amounts deferred attributable to services performed before December 31, 2008 is treated as attributable to services performed before December 31, 2008, but only to the extent further services were not required after December 31, 2008 to retain the right to the earnings.

To the extent that under a plan's terms as of December 31, 2008 a service provider's right to compensation is subject to a substantial risk of forfeiture in the form of a requirement to continue to perform substantial future services after December 31, 2008, the compensation will be considered attributable to the entire period of time in which such services are required to be performed (e.g., a portion may be attributable to the period on or prior to December 31, 2008 and a portion may be attributable to the period after December 31, 2008). For these purposes, a plan's terms as of December 31, 2008 include only the plan's terms as in effect on December 31, 2008, and do not include any amendment to such plan terms after December 31, 2008 (even if the amendment to such plan terms is made effective retroactively to a date earlier than January 1, 2009).

Notwithstanding the foregoing, the terms of a plan may be amended retroactively to provide that a substantial risk of forfeiture that would otherwise lapse on or after January 1, 2009 will be treated as having lapsed effective before January 1, 2009, provided that the amendment is made in writing and effective before July 1, 2009, and provided further that any shortening of the period during which a deferred amount was subject to a substantial risk of forfeiture must be applied consistently to every service provider participating in that arrangement or a substantially similar arrangement.

Taxpayers may rely on Notice 2009-8 in applying Code Section 457A from its effective date. Although the Treasury Department and the IRS intend to issue further guidance with respect to Code Section 457A, Notice 2009-8 specifies that any future guidance that would expand the coverage of Code Section 457A will be prospective and will not apply to taxpayers' taxable years beginning before the issuance of such guidance.

Coordination with Code Section 409A

Code Section 457A and Code Section 409A may both apply to amounts deferred under the same arrangement. Notice 2009-8 provides coordination rules. For example, an inclusion in income under Code Section 457A will be treated as a payment for purposes of the Code Section 409A short-term deferral exception.

Solely with respect to a deferred amount attributable to services performed before January 1, 2009, a change in the time and form of payment to conform the payment date to the date the amount may be required to be included in income under Code Section 457A will not be treated for purposes of Code Section 409A as an impermissible acceleration for amounts subject to Code Section 409A or a material modification for amounts that are grandfathered under Code Section 409A and not subject to Code Section 409A so long as such change is made in writing and effective on or before December 31, 2011.

In general, an amount subject to Code Section 457A will not be subject to Code Section 409A because such amount will be able to qualify for the short-term deferral exception under Code Section 409A since it will be considered to be "paid" no later than the time at which the right to the amount is no longer subject to a substantial risk of forfeiture. The applicable plan need not contain a plan provision stating the foregoing. However, Notice 2009-8 notes that payment timing issues under Code Section 409A may arise in a future

year in certain instances, including if amounts not previously subject to Code Section 457A become subject to Code Section 457A (*e.g.*, because the payor becomes a nonqualified entity) or if amounts previously subject to Code Section 457A cease to be subject to Code Section 457A (*e.g.*, the payor ceases to be a nonqualified entity). Notice 2009-8 provides that until further guidance is issued, the payment of a deferred amount during the service provider's taxable year in which such amount becomes includible in income under Code Section 457A will not constitute an impermissible acceleration under Code Section 409A.

With respect to a back-to-back arrangement under which a service provider provides services to a service recipient (the intermediate service recipient) that in turn provides services to another service recipient (the ultimate service recipient), to the extent the arrangement is covered by Code Section 409A, all potential times and forms of payment under which the service provider may be paid a deferred amount by the intermediate service recipient must comply with the requirements of Code Section 409A. This means that the service provider must be payable upon a permissible payment event, which may include the service provider's separation from service. However, a nonqualified deferred compensation arrangement that provides for the service provider to be paid when the intermediate service recipient separates from service from the ultimate service recipient is not a permissible payment event.

Notice 2009-8 generally does not alter such Code Section 409A requirements. However, a change in the time and form of payment of an amount deferred under such a back-to-back arrangement (which is attributable to services performed before January 1, 2009) solely to conform the date of payment to the date the amount is required to be included in income under Code Section 457A will not be treated as an impermissible acceleration under Code Section 409A, provided that such change in the time and form of payment is established in writing and effective on or before December 31, 2011. In addition, to the extent a deferred amount covered by Code Section 457A was earned and vested before December 31, 2004, and is not otherwise subject to Code Section 409A due to the application of the effective date rules under Treasury Regulations Section 1.409A-6, a change in the time and form of payment solely to conform the date of distribution to the date the amount is required to be included in income under Code Section 457A will not be treated as a material modification of such arrangement, provided that such change in the time and form of payment is established in writing and effective on or before December 31, 2011.

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