**To Our Clients and Friends** **October 15, 2008**

# New Legislation Penalizes Deferred Compensation from Certain Foreign Corporations and Partnerships

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The recently enacted Emergency Economic Stabilization Act of 2008 added a new provision to the Internal Revenue Code ("Code") that will adversely affect certain deferred compensation arrangements. The provision is more stringent in key respects than Code section 409A ("section 409A"), which was added in 2004 to regulate nonqualified deferred compensation. Although the provision was aimed at the deferred compensation of hedge fund and private equity fund executives who manage offshore funds, it can also apply to "domestic" partnerships that have foreign partners or tax-exempt partners such as pension funds.

The new provision applies to deferred compensation arrangements involving payments for services provided to certain foreign corporations and to partnerships with partners that are foreign persons or organizations exempt from U.S. income tax. It applies to deferred amounts that are attributable to services performed after 2008.

## Deferred Compensation Plans That Are Affected

New Code section 457A ("section 457A") provides that any compensation which is deferred under a "nonqualified deferred compensation plan" of a "nonqualified entity" will be includible in gross income when the compensation is earned and when there is no "substantial risk of forfeiture" of the right to the compensation.

A "nonqualified deferred compensation plan" ("nonqualified plan") is defined as any plan that is a nonqualified deferred compensation plan under section 409A,[1] and may include a right to compensation based on the appreciation in value of equity units issued by the entity for which the services are performed. Section 457A may therefore apply, for example, to a stock appreciation right or "SAR," even though many SARs are not subject to section 409A. An amount will not be considered to be deferred for these purposes, and therefore will not be subject to the new provision, if it is paid within 12 months after the end of the tax year of the entity during which the right to the amount was no longer subject to a substantial risk of forfeiture.

The definition of a "nonqualified" entity" is broad. It includes:

- Any foreign corporation, unless substantially all of its income is effectively connected with the conduct of a trade or business in the United States or is subject to a comprehensive foreign income tax,

- Any partnership (domestic or foreign), unless substantially all of its income is allocable to persons other than:
    - Foreign persons with respect to which such income is not subject to a comprehensive foreign income tax, and
    - Organizations that are generally exempt from income tax under the Code. This would include, for example, pension funds and not-for-profit organizations such as charities.

  A foreign person will be considered to be subject to a comprehensive foreign income tax if the person resides in a foreign country and is eligible for benefits under a comprehensive income tax treaty between that country and the United States.

Thus, nonqualified plans of foreign corporations formed and doing business in tax haven jurisdictions will generally be subject to this provision. Nonqualified plans of a domestic or foreign partnership, if a substantial portion of its income is allocable to (i) foreign persons that are not subject to a comprehensive foreign income tax or (ii) organizations generally exempt from U.S. tax also will be subject to section 457A. In particular, this provision may apply to the nonqualified plans of partnerships formed and doing business exclusively in the United States, if a significant portion of their income is allocable either to foreign persons not subject to a comprehensive foreign income tax or to U.S. tax-exempt organizations.[2]

**Effective Dates**

Section 457A is generally effective for deferred amounts that are attributable to services performed after December 31, 2008. It will also apply to amounts attributable to services performed before January 1, 2009, if such amounts are not otherwise includible in income in a taxable year beginning before 2018.

Apparently, to address the potential difficulties under the new provision with respect to existing arrangements that defer amounts earned before 2009 to 2018 or later, Treasury has been directed to issue guidance, within 120 days of the date of enactment (October 3, 2008), to provide a limited period of time during which nonqualified plans relating to services performed before 2009 may be amended, without violating section 409A, so as to cause the distribution dates to be conformed to the dates the deferred amounts are required to be included in income.

**Illustration of the Impact of Section 457A**

The general rule is that deferred amounts are required to be included in income under section 457A once they cease to be subject to a substantial risk of forfeiture. In general, the rights of a person are considered subject to a substantial risk of forfeiture only for so long as the right to compensation is contingent upon the future performance of substantial services by any individual. However, compensation subject to a substantial risk of forfeiture may also include (to the extent provided in regulations) a right determined solely by reference to the gain recognized on the disposition of an investment asset.

Consider the following example. An agreement between a foreign corporation and its U.S. employee provides that if the employee works for the corporation through the end of the next calendar year (the performance period), the employee will be entitled to receive a payment five years after the end of the performance period, with the payment being an amount initially determined at the end of the performance period but subject to upward or downward adjustment based on the performance of, say, a broad-based stock index or the financial portfolio of the foreign corporation itself during the five-year period.

While this arrangement may well be compliant with section 409A, a problem could exist under section 457A. If the foreign corporation is a nonqualified entity, the compensation right would likely be considered to cease to be subject to a substantial risk of forfeiture at the end of the performance period, and be includible in income at that time even though the amount deferred is not payable until five years later.

If the deferred payment was determined, instead, as a percentage of the gain realized with respect to the disposition of the shares of stock of Corporation X held by the foreign corporation as a passive investment, then, pursuant to regulations to be issued, the right to the payment may be considered to be subject to a substantial risk of forfeiture up to the date the shares of stock of Corporation X are sold.

If the amount of deferred compensation is not determinable at the time the substantial risk of forfeiture ends (or when deferred, if there is no substantial risk of forfeiture to begin with -- as is often the case in the context of a management agreement between an offshore hedge fund and its U.S.-based manager), the deferred amount will be includible in income when it is determinable. In those circumstances, penalties similar to those imposed under section 409A (on arrangements not compliant with section 409A) will apply. Specifically, an additional tax equal to 20% of the compensation will be imposed, in addition to regular income tax; and an interest charge will be imposed, computed by applying an IRS-determined interest rate to the tax underpayment that would have occurred if the deferred compensation had been included in income in the year in which the compensation was deferred, or in the year in which the deferred compensation ceased to be subject to a substantial risk of forfeiture.

The adverse treatment described above, for amounts not determinable at the time the amount is first deferred or at the time any substantial risk of forfeiture lapses, suggests that it is expected that compensation arrangements of nonqualified entities will generally be structured or restructured to avoid any deferral of compensation within the scope of section 457A or, if there is a substantial risk of forfeiture, any deferral beyond the time of lapse of the substantial risk of forfeiture.

**Unanswered Questions**

There are numerous unanswered questions (presumably to be addressed by Treasury regulation or other IRS guidance) relating to the new provision, including: which foreign persons will be considered subject to a comprehensive foreign income tax; the magnitude of an interest of a foreign person (not subject to a comprehensive income tax) or tax-exempt partner in a partnership owned predominantly by U.S. taxable persons and/or foreign persons subject to comprehensive income tax regimes, that will cause the partnership to fail the “substantially all” test and therefore be considered a nonqualified entity; and the scope of the exception for compensation based on gain from the disposition of an investment asset that will allow for compensation to be postponed at least until the disposition of the asset by reference to which the compensation is determined.

Notwithstanding these questions, parties to nonqualified plans that may be affected by the new provision should consult with their advisors before the end of this year to determine whether, and in what manner, their existing arrangements should be amended.

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[1] Service providers using the accrual method of accounting should note, however, that the Joint Committee on Taxation report describing section 457A indicates that the new provision may apply to any compensation of a service provider (for example, a management firm) that is deferred under a nonqualified plan of a nonqualified entity, without regard to the method of accounting used by the service provider. By contrast, the application of section 409A is generally limited to deferred compensation earned by service providers that use the cash method of accounting.

[2] According to the Joint Committee on Taxation report describing the new provision, however, a partnership, the income of which is "unrelated business taxable income" under Code section 512, and therefore generally subject to tax even to the extent allocated to an organization exempt from tax under the Code such as a charity qualifying under Code section 501(c)(3), will not be subject to this provision by reason of the tax-exempt partner. More generally, the report indicates that if substantially all the income of a partnership is allocable to partners in whose hands the income is subject to U.S. income tax or a comprehensive foreign income tax, the partnership should not be considered a nonqualified entity.