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Code Section 457A: Deadline Alert and Review

- **June 30 Deadline for Electing Transition Relief**
- **Section 457A Can Impact Operating Partnerships and PE Funds**
- **Hedge Fund Side Pocket Exception Still Unaddressed**

June 30, 2009 is the deadline for taking advantage of some special relief granted by the Internal Revenue Service in guidance released last January under Internal Revenue Code Section 457A (IRS Notice 2009-8). A second elective relief provision carries a December 31, 2011 deadline. IRS Notice 2009-8 left many important questions unanswered about how Section 457A works.

The June 30 deadline is likely of greatest interest to hedge funds that failed to fully service-vest old offshore deferrals before the end of 2008 but would now like to take greater advantage of Section 457A's grandfathering rules.

This Client Alert revisits the Section 457A rules, describes IRS Notice 2009-8 and the special elections for transition relief and supplements our October 20, 2008 Client Alert on Section 457A.

Background

Section 457A is the 2008 tax law that renders ineffective many nonqualified deferred compensation plans -- primarily the kinds of plans previously used by managers of offshore hedge funds to defer taxes on management incentive fees. Section 457A curtails nonqualified deferred compensation by taxing income when it vests rather than when paid, in cases where payment is significantly deferred after vesting. If the amount of the deferred compensation is not determinable when it vests, Section 457A allows the recognition of income to be deferred but imposes penalty taxes when the amount becomes determinable (typically, when the amount is ultimately paid). For purposes of Section 457A, the right to payment vests when such right is no

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longer conditioned on the future performance of substantial service, even if substantial performance-based vesting conditions continue to apply.

Section 457A applies to deferred compensation arrangements sponsored by (i) any foreign corporation unless at least 80% of its income is taxable in the U.S. or substantially all of its income is subject to a comprehensive foreign income tax or (ii) any partnership where more than 20% of its gross income is directly or indirectly being allocated to U.S. tax exempts or foreign persons not subject to a comprehensive foreign income tax and not investing through a "blocker."

Section 457A was largely aimed at blocking deferred compensation plans for managers of offshore hedge funds. In our experience, the mere enactment of Section 457A led many hedge funds to abandon non-grandfathered arrangements. However, as written, Section 457A can apply to operating partnerships that maintain deferred compensation plans or phantom equity plans for managers of the operating business, even if all operations are conducted in the U.S. This might occur, for example, where an operating business is conducted through a partnership in which one or more private equity funds has invested and where U.S. state government pension plans are a significant part of the investing group.

For purposes of Section 457A, payouts contingent on investment realization are *not* regarded as *unvested* unless additional services are required. As a result, compensation contingent on investment return without regard to additional service is generally subject to Section 457A and its penalties, in cases where payment is significantly deferred after service-based vesting. The statute provides for an exception (to be implemented by regulation) where compensation is based solely on the return on a passive investment in a single asset, not netted against other investment returns. Although this exception would seem to be aimed at allowing deferral of taxation (without penalties) until realization of hedge fund "side pocket" investments, the statutory exception, as written, seems too narrow to be useful to many real-world arrangements, because hedge funds often aggregate the results of a side pocket realization with other investments.

Highlights of IRS Notice 2009-8

IRS Notice 2009-8 offers limited transition relief from Section 457A's anti-deferral rules. As a general rule, Section 457A partially applies to deferred compensation which is awarded before 2009 but which only fully service-vests after 2008. However, under IRS Notice 2009-8, plan sponsors can elect on or before **June 30, 2009** to retroactively service-vest compensation as of December 31, 2008. This election permits a currently non-grandfathered arrangement to be grandfathered under Section 457A and thus remain deferred up through the 2017 tax year. Absent an election, deferred compensation which service-vests after 2008 is not exempt from Section 457A and will generally be taxable upon vesting to the extent attributable to post-2008 services.

The IRS interim guidance resolves some open issues but not all. For example, the interim guidance does not clarify the possible application of Section 457A to operating partnerships. Without such clarification, the conservative approach is to treat partnership income allocated to tax-exempt government pension plans investing in operating partnerships as counting toward the more-than-20% threshold which makes Section 457A apply to such partnership's deferred compensation arrangements.

Similarly, current guidance does not address how the single asset exception will be implemented, or if it will be implemented in a meaningful way for hedge fund side pocket investments.

Who is Affected?

In General; Nonqualified Employers. Section 457A applies to deferred compensation arrangements between a U.S. taxpaying service provider and a *nonqualified employer*. Affected nonqualified employers include (i) foreign corporations, unless "substantially all" of the corporation's income is taxable in the U.S. or is subject to a comprehensive foreign income tax and (ii) partnerships (domestic or foreign) with substantial participation by investors who are not subject to U.S. income tax (including U.S. private and public pension plans) or to a comprehensive foreign income tax.

Service Providers. A service provider subject to Section 457A can be an individual, a corporation, S-corporation, partnership or personal service corporation or qualified personal service corporation (or similar noncorporate personal service entity), *without regard to such service provider's method of accounting*. For example, an accrual method taxpayer may be permitted to defer performance-based compensation under its method of accounting, but will be subject to Section 457A on such deferred amounts, assuming it is service-vested. (In contrast, Section 409A does not apply to deferred compensation arrangements for accrual-basis taxpayers.) However, an independent contractor providing services (other than management services) to multiple unrelated clients whose deferred compensation arrangement is exempt under Section 409A is not a service provider for purposes of Section 457A.

Timing of Determination/Identifying the Plan Sponsor. A foreign corporation or partnership is a nonqualified employer if it satisfies the definition on the last day of each of the service provider's taxable years in which he or she is vested but the deferred compensation remains unpaid (the "testing date"). The Treasury may in the future adopt an alternative approach to determine how, if at all, Section 457A will apply where the plan sponsor becomes a nonqualified employer after the testing date but before the compensation is paid. A nonqualified employer is a plan sponsor of a deferred compensation plan if, on the last day of the year in which the testing date occurs, it would be entitled to a compensation deduction under U.S. federal income tax principles if it had paid the deferred amount in cash during such year.

Foreign Corporations. Under IRS Notice 2009-8, a foreign corporation is a nonqualified employer unless at least 80% of its gross income is U.S. source "effectively connected income" (ECI) or substantially all of its income is subject to a "comprehensive foreign income tax." In general, substantially all of a foreign corporation's income is subject to a "comprehensive foreign income tax" if (i) the foreign corporation is eligible for the benefits of an income tax treaty between the U.S. and its resident country (other than Bermuda and the Netherlands Antilles) after taking into account treaty provisions limiting benefits; (ii) it is not taxed by the resident country under a preferential income tax regime; and (iii) the amount of "non-resident source income" excluded under the laws of the resident country (by exemption, deduction or other means) does not exceed 20% of the foreign corporation's gross income for that year (excluding from the 20% any nonresident source income that is ECI or from dividends from a U.S. corporation or a foreign corporation that is itself subject to a comprehensive foreign income tax). IRS Notice 2009-8 includes additional rules related to evaluating applicable income tax treaties and income sourcing.

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A special rule excludes from Section 457A deferred compensation of a foreign corporation that is deductible against the corporation's ECI if it had been paid in cash on the date it vests. Also, a foreign corporation that demonstrates to the Treasury Secretary that it resides in a country that subjects it to a comprehensive income tax (and that otherwise satisfies clauses (ii) and (iii) in the paragraph immediately above) is deemed not to be a nonqualified employer. IRS Notice 2009-8, however, does not provide any guidance on the procedure for this demonstration, including, for example, whether the Secretary will establish a broadly-applicable list of satisfactory countries or make the determination on a case-by-case basis.

Partnerships. Under IRS Notice 2009-8, a partnership avoids nonqualified employer status if it allocates at least 80% of its gross income to "eligible persons" during the partnership's tax year within which the testing date occurs. Partnership gross income is allocated to eligible persons to the extent it is allocated (directly or through tiered partnerships) to:

- U.S. persons (other than (i) tax-exempts, (ii) domestic partnerships and (iii) trusts and estates where such trust or estate is not subject to U.S. income tax on its partnership income and where such income is neither included in the gross income of the beneficiary nor paid or permanently set aside for a charitable purpose);
- foreign persons with respect to whom such income is subject to a comprehensive foreign income tax (determined under a test similar to the one discussed above);
- foreign persons with respect to whom such income is ECI (and not exempt from U.S. federal income tax pursuant to a treaty); or
- a U.S. tax-exempt with respect to whom such income is unrelated business taxable income (UBTI).

A special rule provides that a partnership that does not yet have a taxable year before or ending on a testing date may use a reasonable, good faith estimate of partnership income allocation for its current tax year.

Practical Issues. The complexities of the rules raise a host of practical difficulties to making the determination that nonqualified deferred compensation is exempt from Section 457A. For example, whether an entity is a partnership or corporation is determined under U.S. tax principles without regard to the tax principles of the jurisdiction under which the entity is subject to taxation. Thus, a foreign entity which is regarded as a partnership under U.S. tax principles is tested under Section 457A's nonqualified employer test relevant to partnerships even if it is subject to a comprehensive foreign income tax. Similarly, a foreign entity which is regarded as a corporation under U.S. tax principles is tested as a foreign corporation even if it is taxed on a pass-through basis in its country of residence and its owners pay income tax on their allocations. Also, whether a partnership in a tiered partnership is a nonqualified employer depends on how parent partnership income is allocated, and this information may not be readily available to the person making the determination. Finally, because the nonqualified employer test is run each year that the amount is deferred beyond vesting, the determination that compensation is exempt from Section 457A must be made on a year-to-year basis.

Plans Affected

Section 457A applies to deferred compensation arrangements subject to Section 409A and equity appreciation rights whether or not subject to Section 409A.

Exception for Stock Options and Some SARs. IRS Notice 2009-8 exempts from Section 457A nonstatutory and statutory stock options exempt from Section 409A. IRS Notice 2009-8 also provides a narrow exception from Section 457A for stock appreciation rights (SARs) exempt from Section 409A if by their terms they must be settled in service recipient stock and are in fact so settled. As with Section 409A, profits interests in a partnership are exempt from Section 457A.

Exception for Short-term Deferrals. Section 457A does not apply if compensation is paid out within 12 months after the end of the employer's taxable year (or, if later, within 2-1/2 months after the end of the service provider's taxable year) in which service-related vesting conditions are satisfied. Section 457A's short-term deferral rule seems to be satisfied where payment is actually made within the 12-month period even if the written terms of an arrangement do not require it.

Amount and Timing of Income Inclusion

Determinability. The general rule under Section 457A is that nonqualified deferred compensation is includable in income in the year in which the amount vests. If the amount of compensation is not determinable when it becomes taxable, it is taxed when it becomes determinable, but is subject to substantial penalties on the tax payment date, including a 20% penalty tax on the amount of compensation and a "premium interest tax" on the compensation (which is the amount of interest at the underpayment rate plus 1 percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred, or if later, when it service-vests). An amount is not "determinable" if it is unknown as of the end of the employee's tax year typically due to factors that remain variable. IRS Notice 2009-8 clarifies that an amount is determinable if it is based on information in existence even if not readily available. For example, a bonus amount dependent on the profits of a tax year that has just closed is determinable, even if the accounting calculations are not yet available.

Earnings and Future Losses. Rights to reasonable earnings on nonqualified deferred compensation are includible in income when they vest even after the original amount has been included in income. If an amount is included in income but, for some reason, is never paid, the service provider will be entitled to a loss under rules similar to the proposed rules applicable to Section 409A.

Coordination with Section 409A

Until further guidance, payment of a deferred amount during the service provider's taxable year in which the amount becomes includible in income under Section 457A will not constitute an impermissible acceleration under Section 409A. This rule would permit accelerations where, for example, an employer not subject to Section 457A at the time of deferral later becomes a nonqualified employer and, as a result, the deferred compensation of its employees becomes includible in income under Section 457A on a date earlier than the payment date previously fixed for purposes of complying with Section 409A.

Back-to-Back Arrangements

IRS Notice 2009-8 provides preliminary guidance under Section 457A for back-to-back arrangements -- for example, where an employee's deferral of compensation from an employer is matched against the employer's deferral of compensation from the ultimate service recipient (for example, the investment fund itself). To the extent the back-to-back arrangement is subject to Section 409A, the time and form of payments under which the employee may be paid by the employer must conform to the Section 409A rules dealing with permissible payment events, which generally permit payment upon the employee's separation from service from his or her employer. However, IRS Notice 2009-8 states that the employer's separation from service from the ultimate service recipient is not a permissible payment event under Section 409A for payment to the employee.

Effective Dates and Transition Relief Elections

Grandfathering and Service Period Attributions. The new rules apply to amounts deferred which are attributable to services performed after December 31, 2008. In order to avoid penalty taxes, amounts attributable to services performed before 2009 must generally be brought into income by the later of vesting or the 2017 tax year. Generally speaking, amounts are attributable to a period based on the plan formula in effect as of December 31, 2008, if any, or when the employee obtains a legally binding right to the compensation. If compensation is attributable to both pre-2009 and post-2008 periods (e.g., where the service-based vesting period bridges 2008 and 2009), the amount attributable to each period is determined on a pro rata basis over the vesting period. If the actual service period is shortened or accelerated for any reason (e.g., early payout due to employee's death or disability), the original income allocation remains unaffected.

Transition Relief Elections. Importantly, IRS Notice 2009-8 allows retroactive changes to be made to existing arrangements to permit accelerated service-based vesting of benefits to December 31, 2008. Doing so will permit payments under such arrangements to be deferred so long as the compensation is brought into income before the 2018 tax year. To take advantage of this transition relief, any ongoing service-based vesting condition in existence on December 31, 2008 must be eliminated. The change must be made in writing and effective on or before **June 30, 2009** and must be made consistently to all other service providers participating in that arrangement and substantially similar arrangements.

IRS Notice 2009-8 also permits a change to the time and form of payment of amounts grandfathered for purposes of Section 457A in order to conform the date of distribution to the date of income inclusion (for example, to cause distributions to be made in 2017). If in writing and effective on or before **December 31, 2011**, the change will not be deemed an impermissible acceleration under Section 409A or a material modification of a Section 409A-grandfathered arrangement. This election also applies to back-to-back arrangements under which any amount is attributable to services performed before 2009.

What Should You Do Now?

To the extent not previously done, employers potentially subject to Section 457A should review their compensation arrangements and, if need be, their corporate or organizational structures soon, so as to quickly identify arrangements that are affected by Section 457A and consider what adjustments may be necessary or desirable in light of the law and whether to take advantage of the transition relief.

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This alert is not intended to provide legal advice, and no legal or business decision should be based on its content.

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