Financial Institutions

E-ALERT

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IRS Issues Guidance on Deferred Compensation of Nonqualified Entities under Section 457A

The IRS has issued interim guidance interpreting Section 457A of the Internal Revenue Code, which was adopted as part of the Emergency Economic Stabilization Act of 2008. Section 457A generally requires deferred compensation paid or payable under a "nonqualified deferred compensation plan" of a "nonqualified entity" that is attributable to services performed after December 31, 2008 to be included in income when it is no longer subject to a substantial risk of forfeiture (i.e. upon vesting). In addition, if the amount of the deferred compensation cannot be determined at the time of vesting, the compensation will be taxed when the amount is determinable and included in income, but will be subject to an additional 20% income tax (on top of regular income tax) plus premium interest.

The interim guidance, provided in Notice 2009-8, clarifies the meanings of "nonqualified deferred compensation plan" and "nonqualified entity" and addresses when amounts must be included in income. Treasury and the IRS anticipate issuing further guidance, including possible modification of the initial guidance to expand the definition of a "nonqualified entity." Any future guidance will apply only on a prospective basis.

After Section 457A was enacted, there was significant concern that, although it was intended to prevent the offshore deferral of fees by hedge fund managers, it could pick up traditional deferred compensation arrangements with U.S. taxpayers working for (i) certain foreign corporations and (ii) U.S. or foreign operating partnerships, or foreign operating corporations, that are portfolio companies owned by private equity and venture capital funds. The interim guidance confirms that Section 457A could apply to these arrangements.

HIGHLIGHTS OF 457A INTERIM GUIDANCE

- "Deferred compensation" under 457A generally has the same broad meaning as under 409A, except that amounts attributable to services performed before January 1, 2009 generally are not subject to 457A.
- In addition to payments that constitute short term deferrals under 409A, payments made within 12 months after the end of an employer's taxable year in which the compensation vests are exempt from 457A.
- Deferred compensation plans subject to 457A may be amended retroactively before ***July 1, 2009*** to accelerate the vesting of deferred compensation to the period before 457A is effective so that such amounts are not subject to immediate taxation under 457A.
- Deferred compensation plans subject to 457A may be amended before ***December 31, 2011*** to change the time and form of payment of deferred compensation in respect of pre-2009 services so that the timing of the compensation's distribution conforms to the date of its inclusion in income.

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Section 457A eliminates the ability of service providers to nonqualified entities, most notably the U.S. managers of offshore hedge funds, to defer income tax on compensation from such entities for years after the compensation has vested. Compensation attributable to services performed after December 31, 2008 is now taxed upon vesting irrespective of when it is paid. Under pre-457A deferred compensation arrangements, this creates an unfortunate mismatch between the date on which the tax is owed and the date on which the monies to pay the tax are received. To avoid this consequence, entities should avail themselves of the transition rules to amend their plans either to avoid the application of 457A by accelerating vesting to a period before the statute's effective date or to conform the date of distribution of income to the date of its taxation.

WHAT IS DEFERRED COMPENSATION UNDER SECTION 457A?

The interim guidance clarifies that the terms "deferred compensation" and "nonqualified deferred compensation plan" under 457A have the same broad meanings as provided in Section 409A, i.e. compensation to which a service provider has a legally binding right in one year that is payable in a subsequent year, including most (but not all) of the same exemptions.

With respect to equity compensation, as with 409A, Section 457A does not apply to each of (i) a profits interest in a partnership, (ii) stock options issued with an exercise price not less than fair market value on the date of grant and (iii) restricted stock of a corporation or an equity interest in a noncorporate entity. However, the exemption for stock appreciation rights (SARs) under 457A is more limited than under 409A. In addition to the requirement that the SARs must be struck at no less than fair market value of the reference equity on the date of grant, the SARs must be required to be (and must be) settled in service recipient (i.e. the employer's) stock, not cash.

As with 409A, there is an exemption for compensation paid within a short time period following its vesting (known as a short term deferral exemption), although this exemption is broader in Section 457A. Under 457A, a payment is considered made within the short term deferral period, and thereby exempt from 457A, if it is paid (i) within 12 months after the end of the service recipient's (e.g. the employer's) taxable year in which the compensation vests or (ii) no later than the 15th day of the third month following the end of the service provider's (e.g. the employee's) first taxable year in which the compensation vests. However, one important distinction between 409A and 457A is that the only qualifying vesting condition under 457A (i.e. the test for "substantial risk of forfeiture") is the future performance of substantial services by the service provider. In other words, once the employee has the right to compensation whether or not he or she continues working, the compensation must be included in the employee's income, and the short term deferral period is measured from this date and not the date of any other vesting condition to which the compensation may be subject. (Under 409A, the "occurrence of a condition related to a purpose of the compensation" (such as a prescribed level of earnings or the future occurrence of an IPO) can also constitute a substantial risk of forfeiture.)

As mentioned above, under 457A, nonqualified deferred compensation payable by a nonqualified entity must be included in income in the year in which the amount is no longer subject to a substantial risk of forfeiture. However, an amount that is not determinable when it vests is instead included in income in the year in which it becomes determinable, and is subject to an additional 20% income tax and premium interest when taxed. (This approach contrasts with the FICA rule, which permits an employer, without penalty, to include an amount as taxable for FICA purposes in the year in which it becomes "reasonably ascertainable.") For purposes of 457A, an amount is considered not to be "determinable" if it depends on factors that are variable at the end of the applicable taxable year.

WHAT IS A "NONQUALIFIED ENTITY" UNDER SECTION 457A?

Section 457A only applies to "nonqualified entities" that are plan sponsors of deferred compensation. A nonqualified entity is either a non-U.S. corporation or a U.S. or non-U.S. partnership that meets certain requirements. The "nonqualified entity" must be the sponsor of the deferred compensation plan, meaning it is the entity entitled to deduct the deferred compensation under U.S. tax rules, regardless of whether it grants or pays such compensation.

A non-U.S. corporation is a nonqualified entity unless (i) at least 80% of its gross income is "effectively connected with" the conduct of a U.S. trade or business that is not exempt from U.S. federal income taxes pursuant to a treaty obligation of the U.S. or (ii) substantially all its gross income is subject to a comprehensive foreign income tax. For purposes of clause (ii), the non-U.S. corporation must (A) be eligible for the benefits of a comprehensive income tax treaty between its country of residence and the U.S. (other than the treaties with Bermuda and the Netherlands Antilles), (B) not be taxed under any regime that is materially more favorable to such entity than the corporate income tax otherwise generally imposed by such country of residence, and (C) not have nonresidence source income that is excluded from the foreign tax for the relevant tax year that exceeds 20% of its gross income for the year. (A non-U.S. corporation may also avoid treatment as a nonqualified entity if it can demonstrate to the satisfaction of the Secretary of the Treasury that it is resident for tax purposes in a country that has a comprehensive income tax and satisfies the 20% test described in clause (C) above.)

A U.S. or non-U.S. partnership will be deemed a "nonqualified entity" unless 80% or more of its gross income is allocated to "eligible persons." In general, "an eligible person" includes (i) a U.S. tax exempt entity if the gross income is derived from an unrelated trade or business and is taxable to such entity, (ii) a non-U.S. entity if the gross income is effectively connected with the conduct of a trade or business in the U.S. and is taxable to such entity, (iii) a U.S. individual or corporation, and (iv) a non-U.S. entity that is subject to a comprehensive foreign income tax with respect to such gross income, as determined in accordance with the rules for this context in the Notice.

WHAT IS THE EFFECTIVE DATE OF 457A?

Section 457A generally applies to deferred amounts which are "attributable" to services performed after December 31, 2008. Deferred amounts attributable to services performed before January 1, 2009 are not subject to 457A if they will be included in income before January 1, 2018 or if later, the year in which the substantial risk of forfeiture lapses.

The Notice provides numerous examples showing what amounts are subject to Section 457A depending on when the service provider obtains the legally binding right to the compensation and when there is no longer a substantial risk of forfeiture. If compensation is subject to the continued performance of services after December 31, 2008, the service period is pro-rated between the pre-2009 and post-2008 period for purposes of determining what portion of the compensation must be included in income when it vests under 457A. Although a deferred compensation plan's terms generally cannot be retroactively amended after December 31, 2008, the Notice permits a plan to be amended retroactively before July 1, 2009 to provide that a substantial risk of forfeiture that would lapse after January 1, 2009 will be treated as having lapsed before January 1, 2009 so that all deferred compensation under the plan can be attributed to pre-2009 services. Any such reduction of the vesting period must be applied consistently to all service providers participating in the same plan or arrangement.

COORDINATION OF SECTIONS 457A AND 409A?

The guidance also provides transition rules under 409A with respect to amounts covered by 457A that are attributable to services performed on or before, and after, December 31, 2008.

With respect to amounts attributable to services performed before January 1, 2009, the guidance gives employers until December 31, 2011 to modify their deferred compensation plans to change the time and form of payments to conform the distribution date to the income inclusion date without violating Section 409A.

With respect to amounts attributable to services performed after December 31, 2008, in general, the right to a deferred amount to which 457A applies will not constitute a 409A deferred amount because it will be paid for purposes of the 409A short term deferral rule no later than the time that it is no longer subject to a substantial risk of forfeiture. The Notice states that, until there is further guidance, the payment of a deferred amount during the service provider's taxable year in which such amount is included in income under 457A will not constitute an impermissible acceleration of payment under 409A.

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