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IRS Issues Guidance Regarding the Limitations of the Emergency Economic Stabilization Act of 2008 on Offshore Deferrals

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Introduction

As previously reported, the Emergency Economic Stabilization Act of 2008 (the Act), which was enacted in October 2008, significantly limits the ability of certain offshore entities to defer compensation to U.S. taxpayers. Specifically, the Act added Section 457A to the Internal Revenue Code (the IRC), which generally imposes unfavorable tax treatment on taxpayers deferring compensation that is received from entities located in certain foreign tax havens. In January, the Internal Revenue Service (the IRS) issued Notice 2009-8, which provides interim guidance with respect to the application of Section 457A.

Background

Section 457A of the IRC provides that compensation deferred under a nonqualified deferred compensation plan of a "nonqualified entity" will be subject to immediate taxation. In general, a nonqualified entity is a foreign entity that is not subject to (i) the IRC or (ii) a "comprehensive foreign income tax" (as described below). If the value of such compensation is not determinable at the time it is earned, then it will be included in the taxpayer's income in the year in which its value is determinable and will be subject to an interest charge, as well as an additional 20% tax.

Nonqualified Deferred Compensation Defined

Notice 2009-8 generally adopts the definition of nonqualified deferred compensation provided under Section 409A of the IRC with certain exceptions. One notable exception is that equity appreciation rights (with a limited exception for certain stock-settled equity appreciation rights) may provide for nonqualified deferred compensation, and therefore be subject to Section 457A, even if they are granted with an exercise price equal to or greater than fair market value on the date of grant. However, statutory stock options and nonqualified stock options, which have an exercise price of not less than fair market value on the date of grant and which do not have any other deferral feature, generally do not constitute nonqualified deferred compensation subject to Section 457A.

Notice 2009-8 clarifies that amounts that would constitute a short-term deferral under Section 409A (generally amounts paid prior to the later of (i) 2½ months following the last day of the service

provider's taxable year in which the substantial risk of forfeiture lapses or (ii) 2½ months following the last day of the service recipient's taxable year in which the substantial risk of forfeiture lapses) will not constitute nonqualified deferred compensation for purposes of Section 457A, as long as the substantial risk of forfeiture meets the requirements of Section 457A. As opposed to Section 409A, which provides that a substantial risk of forfeiture may generally include attainment of certain performance goals, Section 457A generally limits a valid substantial risk of forfeiture to a requirement that a service provider perform substantial services in the future.

As an additional exception, amounts will not constitute nonqualified deferred compensation subject to Section 457A if they are paid within 12 months after the end of the taxable year of the service recipient, during which the right to payment is first no longer subject to a substantial risk of forfeiture.

Plan Sponsors Treated as Nonqualified Entities

"Nonqualified entities" are non-U.S. corporations and certain partnerships that sponsor deferred compensation plans or take deductions with respect to U.S. income for deferred compensation. A non-U.S. corporation will generally be treated as a nonqualified entity unless (i) at least 80% of the plan sponsor corporation's gross income is "effectively connected" with the conduct of a trade or business in the United States that is not exempt from U.S. tax pursuant to a treaty with the United States, or (ii) substantially all of its income is subject to a "comprehensive foreign income tax." A comprehensive foreign income tax generally exists where the foreign country (other than Bermuda and the Netherlands Antilles) has entered into an income tax treaty with the U.S. and the non-U.S. corporation is not subject to a more favorable tax regime in its foreign country of residence than the otherwise imposed U.S. corporate income tax regime.

Partnerships may also be nonqualified entities under Section 457A. In general, both U.S. and foreign partnerships will be nonqualified entities unless at least 80% of their gross income is allocated to persons subject to U.S. tax on the partnership income. Notice 2009-8 clarifies that Section 457A applies to plan sponsors, irrespective of whether they account for income on a cash or accrual basis.

Determinable Compensation

As noted above, if compensation that is otherwise required to be included in a taxpayer's income when it is earned is not determinable at that time, it will instead be included in the taxpayer's income in the year in which its value becomes determinable, and will also be subject to an interest charge, as well as an additional 20% tax. Amounts generally will not be considered determinable if they are based on factors that remain unknown.

Grandfathering Provisions

Section 457A generally applies to amounts deferred that are attributable to services performed after December 31, 2008. However, any "grandfathered" deferred amounts attributable to services performed *before* January 1, 2009, which are not otherwise included in gross income in a taxable year beginning before 2018, will be includible in income on the later of (i) the last taxable year beginning before January 1, 2018 and (ii) the first taxable year in which the amount is no longer subject to a substantial risk of forfeiture (as defined by Section 457A). Under certain circumstances, 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 before January 1, 2009 so that deferred amounts may qualify for the more favorable "grandfathered" treatment. Such amendment **must be made in writing and effective prior to July 1, 2009** and any decrease in the vesting period must be applied consistently to every service provider participating in that arrangement or a substantially similar arrangement.

Amounts subject to Section 457A may also be subject to Section 409A, which generally regulates the timing of deferral elections and the time and form of distributions of nonqualified deferred compensation. In the event that amounts are subject to both Section 409A and Section 457A and are attributable to services performed before January 1, 2009, Notice 2009-8 provides special transition relief to allow the sponsor to amend the payment date to match the date the amounts will be includible in income under Section 457A. Such change must be made in writing and effective on or before December 31, 2011. To the extent that such change applies to amounts that otherwise qualified as grandfathered amounts under Section 409A, the amendment will not constitute a material modification.

Substantial Effects on Private Funds

As previously reported, Section 457A will have a substantial impact on many offshore hedge funds organized in certain tax havens (e.g., Bermuda, Hong Kong, and the Cayman Islands). Management and incentive fees paid by such funds will need to be either (i) subject to a "substantial risk of forfeiture" under Section 457A, or (ii) converted to a general partner carried interest in a "master feeder" type of arrangement. In addition, management companies organized in tax havens may no longer be able to offer efficient deferred compensation to their employees who are U.S. taxpayers.

Of course, nothing in Section 457A or Notice 2009-8 limits these restrictions to private funds. As such, many nonqualified entities, as described above, will need to take immediate action to revise their nonqualified deferred compensation arrangements. In particular, the grandfather election referenced above offers an important opportunity that must be acted upon (if at all) prior to July 1, 2009.

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