Thoughts on the Scope and Implications of New Section 457A (Nonqualified Deferred Compensation)

New York
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On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (H.R. 1424) was signed into law. The Act adds new section 457A to the Internal Revenue Code of 1986, as amended (the "Code"). Section 457A requires the inclusion in income of any compensation deferred under a nonqualified deferred compensation plan of a nonqualified entity when the compensation is no longer subject to a substantial risk of forfeiture or, if the amount of compensation is not determinable at that time, when the amount becomes determinable.

As explained in greater detail below, this provision is targeted primarily at typical fee deferral arrangements currently employed by offshore hedge funds. It will, however, likely have implications for deferred compensation both inside and outside the hedge fund area that may or may not have been envisioned by the drafters. The potential application of section 457A should be of concern for:

- U.S. expatriate employees working in countries or jurisdictions that do not have comprehensive income tax treaties with the U.S. (*e.g.*, Hong Kong);
- Non-U.S. employees of foreign employers who become subject to U.S. taxation by virtue of time spent rendering services in the U.S. (although a possible exception may apply in this circumstance);
- U.S. employees working for partnerships (including, for example, joint ventures treated as partnerships for U.S. tax purposes), the partners of which include foreign entities or tax-exempt entities; and
- Entities subject to U.S. tax that are in a service business and that provide services to partnerships or foreign corporations in exchange for fees that are paid after the year in which the services are rendered.

This memorandum is divided into three sections. The first section is a summary overview of the new section 457A and a description of some differences from section 409A. The second section describes how section 457A will likely apply to an ordinary hedge fund compensation arrangement. The third section analyzes the legislative language in greater detail in order to highlight certain ambiguities and identify circumstances outside of the hedge fund context that may become subject to section 457A. The analysis in the memorandum is based solely upon our reading of the legislation and, where applicable, the interpretive gloss added by the Joint Committee on Taxation technical explanation of a predecessor bill (the "JCT Technical Explanation");[1] the statute as it is ultimately applied will likely depend to a large extent on regulations that have not yet been written or other guidance from the Treasury.

I. SUMMARY OVERVIEW OF LEGISLATION.

A. General.

With certain limited exceptions, section 457A applies to amounts under a deferred compensation plan if (i) the plan is a "nonqualified deferred compensation plan;" and (ii) it is maintained by a "nonqualified entity." Section 457A makes such amounts currently includible in income when such amounts are no longer subject to a "substantial risk of forfeiture." If, however, an amount is not "determinable" at the time it would otherwise be includible in income under section 457A (*i.e.*, when there is no substantial risk of forfeiture), the amount is includible in income when it *is* determinable subject to an additional 20% penalty tax and imputed interest (at the underpayment rate plus 1%) as if the deferred compensation had been includible in income as of the time the income was not subject to substantial risk of forfeiture.

Compensation is subject to a substantial risk of forfeiture only if a person's right to the compensation is conditioned upon the future performance of substantial services by any individual (which, as discussed below, is a narrower definition than that applicable under section 409A) or is conditioned upon the disposition of an "investment asset." Other conditions, such as the occurrence of a condition related to the purposes of the compensation (*i.e.*, a contingency based on a business goal of the service recipient), even if the possibility of the risk of forfeiture is substantial, are not considered to give rise to a "substantial risk of forfeiture" under section 457A (hereinafter, "section 457A substantial risk of forfeiture").

Section 457A will apply to deferred compensation attributable to services performed starting January 1, 2009. Deferred compensation attributable to services

[1] The JCT Technical Explanation relates to H.R. 7060, The Renewable Energy and Job Creation Tax Act of 2008 ("H.R. 7060"), which contained an earlier version of section 457A. Section 457A as passed in the final legislation is not entirely identical to the version contained in H.R. 7060. The JCT has not released a technical explanation of H.R. 1424. One significant uncertainty in the interpretation of section 457A as it now stands is the degree to which the JCT Technical Explanation can be relied upon in interpreting the final version of the legislation.

performed prior to that are eligible for a transition rule and can be deferred until the last taxable year of the service provider beginning before 2018 or, if later, the taxable year in which the compensation is no longer subject to a section 457A substantial risk of forfeiture.[2]

Accordingly, section 457A largely eliminates the ability to defer compensation payable from certain entities — very generally, foreign corporations incorporated in tax haven jurisdictions and not subject to U.S. net income tax, or pass-through entities unless the partners are subject to U.S. or foreign tax. It is relevant to any nonqualified deferred compensation of any service provider that is a U.S. person and any foreign person that is subject to U.S. tax in respect of such compensation income, where the compensation is earned from such "nonqualified entities."

B. Differences between Section 457A and Section 409A

Section 457A borrows a number of concepts from section 409A of the Code, which was enacted in 2004 as part of the American Jobs Creation Act.[3] Section 409A imposes strict restrictions on the time and form of payment of nonqualified deferred compensation by any payor (a "service recipient") to a recipient (a "service provider"), subject to certain exceptions specified in section 409A and the regulations thereunder. Generally, section 409A requires all nonqualified deferred compensation to which it applies to be paid out under a fixed schedule or the occurrence of certain specified permissible distribution events. Any payments of nonqualified deferred compensation (as defined under section 409A) that do not satisfy these requirements are subject to tax on the deferred compensation at the time that there is no substantial risk of forfeiture, plus interest on deferred amounts at the underpayment rate plus 1%, plus an additional 20% tax. Section 409A also includes a concept of "aggregation" of deferred compensation plans, such that a violation of the rules with respect to a single payment in one plan can affect all payments to the affected service provider under all plans of the same type (as described in the plan aggregation rules) and cause the aggregated payments to be immediately included in income with interest and the additional 20% tax, as described above.[4] Among the most important exceptions to these rules are: (i) section 409A applies only to cash method service providers

[2] H.R. 1424 section 801(d) provides for the effective date of the new section 457A, although the effective date does not appear as part of the new Code section itself.

[3] Section 409A continues to apply in addition to section 457A.

[4] The plan aggregation rules set forth in the final regulations under section 409A establish nine separate categories of nonqualified deferred compensation; a section 409A violation with respect to compensation in one category will affect all other nonqualified deferred compensation within that category for the affected service provider, but not amounts in the other categories. *See* Preamble to Final Regulations, TD 9321, 72 Fed. Reg. 19249-19250 and Treas. Reg. 1.409A-1(c)(2)(i)).

(presumably under the view that an accrual basis taxpayer generally cannot defer recognition beyond the occurrence of the "all events" test); (ii) section 409A has an exclusion for certain "independent contractors"; and (iii) "short term deferrals" (that is, compensation that is always paid out within 2 ½ months of the end of the taxable year of the service provider in which the amount is no longer subject to a substantial risk of forfeiture) are excluded from the definition of nonqualified deferred compensation and exempt from the rules.

The new section 457A builds in part on the framework under section 409A but is targeted at payments of compensation by a specific group of payors: entities that are indifferent from a tax perspective as to whether their compensation expense is currently deductible. In general, an employer obtains a tax deduction for deferred compensation in the taxable year in which the employee includes the compensation amount in income. The differing interests of the employer (which would prefer an earlier deduction) and the employee (who would prefer deferral) would theoretically discourage arrangements that defer the inclusion of income, other things being equal. This analysis does not, however, apply to tax indifferent parties that do not receive a U.S. tax benefit from a current deduction (*e.g.*, foreign corporations not subject to U.S. net income taxation). Because there is no counterbalance to the tax benefits derived by the service providers from the income deferral, deferred compensation arrangements maintained by tax indifferent parties are considered to give rise to tax benefits at the expense of the U.S. Treasury.

Section 457A was drafted to apply to certain service recipients who are tax indifferent by virtue of their status, and not those who may be tax indifferent at a particular time due to particular circumstances, such as having substantial net operating loss carryovers. On the other hand, as explained below, nonqualified deferred compensation plans of controlled foreign corporations or passive foreign investment companies incorporated in tax haven jurisdictions may be covered by section 457A, even though U.S. shareholders of such foreign corporations may not be tax indifferent as to the timing of the deduction claimed in respect of the compensation expense.

As discussed in greater detail below, there are certain relevant differences between sections 409A and 457A:

- Section 409A applies to compensation paid by any person, while section 457A applies only to compensation paid by a "nonqualified entity."

- Section 409A applies only to cash method service providers, while section 457A (at least according to the JCT Technical Explanation) will apply to any service provider without regard to its method of accounting.[5] This may in certain circumstances significantly accelerate income for an accrual basis service provider that otherwise would not have satisfied the "all events" test,[6] and will in other circumstances potentially make the service provider subject to penalty taxes at the time of accrual. More generally, this will require accrual method service providers (*e.g.*, corporations receiving fee income) that previously were able to ignore section 409A as service providers to become familiar with the relevant concepts to the extent they apply in the section 457A context.

- Section 409A does not apply to independent contractors who provide significant services to at least two unrelated service recipients and meet certain other requirements set forth in the regulations. This exception does not apply to independent contractors to the extent that they provide "management services" (which includes "management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets…such as a hedge fund"). Neither the statutory language of section 457A nor the JCT Technical Explanation suggests that there will be an equivalent exemption from section 457A for independent contractors. Absent a similar exception, the scope of section 457A's application might be dramatically broader than that of section 409A (especially given that section 457A appears to apply to accrual-basis taxpayers), potentially picking up payments of fees to companies and partnerships that are in the business of providing services to numerous clients. One example would be professional services firms whose fee payment arrangements are based on contingencies that would not be considered to amount to a section 457A substantial risk of forfeiture (*e.g.*, where a legal right to payment arises

5 Based on the JCT Technical Explanation of H.R. 7060, which contained an earlier version of section 457A, section 457A applies also to accrual-method taxpayers. H.R. 7060, which is the House's last version of section 457A, included an express definition of service provider which was defined by reference to the regulations under section 409A, but "determined without regard to method of accounting." The final version of section 457A does not contain a definition of service provider.

6 Under the "all events" test, an accrual method taxpayer is required to include an item in income for the taxable year when (i) all events have occurred that fix the right to receive the income and (ii) the amount of the income can be determined with reasonable accuracy. The first requirement of the test (*i.e.*, that a taxpayer's right to income is fixed) is satisfied when either the amount is unconditionally due or the taxpayer has performed. The second requirement (*i.e.*, that the amount be determinable with reasonable accuracy) is met if a reasonable basis for the calculation of an income item exists; it is not necessary that the exact amount be known at the time of accrual.

when work is performed, but payment is contingent on closing of a transaction or completion of a project and might be paid beyond the twelve month deferral period). It would appear to be consistent with the purpose of section 457A to include a similar exemption in the regulations, since this would not affect the application of section 457A to the investment management fees that section 457A primarily aims to regulate.

- Section 409A permits compensation to be deferred beyond the vesting date as long as the deferral arrangement complies with the rules. A service provider subject to section 457A will be subject to the 20% penalty tax and underpayment penalty to the extent the amount of compensation is not "determinable" at the time the substantial risk of forfeiture lapses. Thus, an analysis under section 457A will turn in significant part on whether or not the amount of compensation is "determinable" at the time there is no substantial risk of forfeiture, which is not a relevant concept under section 409A. Unfortunately, in light of the importance of the term, there is no current guidance on the meaning of "determinable," although regulations that will clarify the scope of the term are expected. Given the binary "penalty" or "no penalty" nature of the issue, there may be pressure to avoid compensation arrangements where determinability is in doubt.

- Section 457A defines "nonqualified deferred compensation plan" by cross-reference to section 409A(d), although it also includes any plan that includes a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient. This clearly covers stock appreciation rights ("SARs"), which are exempt from section 409A as long as specified requirements are met, and may (under an anti-abuse rule) cover other similar compensatory arrangements that are excluded from coverage under section 409A. According to the JCT Technical Explanation, section 457A does not apply to transfers of property subject to section 83 (including stock options that are not in-the-money), incentive stock options covered under section 422 or options granted under an employee stock purchase plan covered under section 423. As a result, it appears that section 457A will apply to some arrangements that have substantially similar economic effects as other arrangements that are exempted.

- Section 457A defines "substantial risk of forfeiture" with statutory language very similar to that used in section 409A, but not by cross-reference.[7] The regulations under section 409A have expanded the definition of substantial risk of forfeiture to include entitlements conditioned on the occurrence of a condition related to the purpose of the compensation (*i.e.*, a contingency based on a business goal of the service recipient). One obvious example of this sort of condition would be a substantial risk of forfeiture tied to receipt of a certain level of profits. For purposes of section 457A, "substantial risk of forfeiture" will *not* (according to the JCT Technical Explanation) include such conditions even if the possibility of the risk of forfeiture is substantial. The narrow "investment asset" exception (described in detail in Part II) in section 457A is intended to provide the sole contingency outside of the obligation to continue to provide services. The result is that section 457A may apply even in situations where significant contingencies remain, and in those situations it is very likely that the amounts to be received will not be determinable at the first time there is no substantial risk of forfeiture.

- Section 409A exempts from treatment as nonqualified deferred compensation a payment that by its terms must be made within 2 ½ months after the end of the taxable year of the service *provider* in which there is no longer a substantial risk of forfeiture. Section 457A has a similar concept (subject to the narrower definition of substantial risk of forfeiture as described above) but allows a payment not later than *twelve* months after the end of the taxable year of the service *recipient* during which the right to payment is no longer subject to a substantial risk of forfeiture.[8]

[7] Section 457A says rights to compensation are treated as subject to a substantial risk of forfeiture *only* if such person's rights to compensation are conditioned upon the future performance of substantial services by any individual. Section 409A has the same language, without the "only." We assume that this difference was not inadvertent and that the intention was to clarify that there can be no "substantial risk of forfeiture" that does not require, at least as one prong, the continued performance of services.

[8] In order to qualify as a short term deferral under section 409A, the compensation arrangement must *require* the payment to be made within the 2 ½ month period, and (with limited exceptions) the payment must be actually made within that period. This is set forth in the preamble and regulations to section 409A and is not contained within the Code section itself. Code section 457A contains the twelve month deferral exception and refers only to payment being *received* within the twelve month period. We expect (but do not know) that implementing regulations will add a requirement that in order to qualify for the exception the compensation arrangement must require payment within the requisite period. If a payment is not made within the requisite twelve months after the end of the

II. APPLICATION TO HEDGE FUNDS.

Section 457A was passed to limit deferrals of fees for hedge fund managers and it will undoubtedly be successful in that respect. Many hedge funds are organized in tax haven jurisdictions such as the Cayman Islands or Jersey and their offshore funds (generally for foreign and U.S. tax-exempt investors) are invariably foreign corporations that are not subject to U.S. net income taxation on their activities. Any such offshore hedge fund will be treated as a "nonqualified entity."

In a typical hedge fund compensation arrangement, the hedge fund manager is, pursuant to a management contract with the offshore fund, entitled to a management fee based on the assets under management and is entitled to an incentive fee based on a percentage of the mark to market appreciation in the fund during the year (the so called "2 and 20").[9] Many hedge funds have a separate arrangement with respect to illiquid investments or those that cannot easily be valued on a mark to market basis (a "side pocket"), in which the assets in the side pocket are excluded from the mark to market calculation and incentive fees are paid with respect to gains on the side pocket assets on a realization basis.

Hedge fund managers commonly defer receipt of a portion of their management fees and incentive fees, and notionally reinvest the deferred amounts in the fund. Then, when the deferral has run its course, the fund manager receives the deferred amounts plus (or minus) any notional returns from the notional investment.[10] The hedge fund manager (which is to say, the employees of the hedge fund manager paid on a back to back basis or the owners of the hedge fund manager receiving a distributive share of income) benefits by being able to effectively invest in the hedge fund on a pre-tax basis.[11] The investors in the offshore hedge fund are indifferent to whether or not they take a current deduction because they do not directly or indirectly pay U.S. net income tax (*i.e.*, the

taxable year in which the substantial risk of forfeiture lapses, and section 457A applies, the time period for filing the tax return for that taxable year will already have passed.

9 If a hedge fund has lost value as compared to the prior mark to market value used in computing the incentive fee, the hedge fund generally must appreciate above the "high water mark" before the manager is entitled to any additional incentive fee.

10 Section 409A applies to these deferrals and as a result the deferrals have generally been for a fixed amount of time, with acceleration of the payment solely on permissible section 409A distribution events.

11 The hedge fund managers are entitled to defer recognition of income until receipt of the cash because they are on the cash method of accounting, and the amounts to be paid to them remain subject to the creditors of the hedge fund.

offshore fund is a foreign corporation that is not paying net income tax, and the investors in the offshore fund are generally foreign persons or U.S. tax exempts).

Under section 457A, any deferral of management fees or incentive fees outside the twelve month deferral exception would be subject to current tax at the time the manager has a legal right to the compensation even if amounts are paid out sometime later. As discussed below, we expect that the deferred amount would be treated as "determinable" and the earnings amount would be treated as an additional item of deferred compensation separately subject to section 457A, although it is possible that the entire amount would be treated as not determinable until paid.

To the extent a hedge fund manager is entitled to an incentive fee with respect to side pocket investments at the time they are made (*i.e.*, the manager need not perform future services to be entitled to the compensation at the time the side pocket investment is realized), in the absence of an exception, the right to the incentive fee would likely not be treated as subject to a substantial risk of forfeiture and section 457A would apply. Since the incentive fee is based on the realized profits from the side pocket investment and that amount it is not determinable at the time the side pocket investment is made, that fee would, when received, be subject to the section 457A penalty tax regime. Section 457A does have an exception that was likely intended to exclude certain side pocket compensation arrangements from its scope: under regulations to be issued, compensation determined solely by reference to gains recognized on disposition of an "investment asset" is to be treated as subject to a substantial risk of forfeiture until the date of the disposition. As a result such compensation would not be subject to section 457A so long as it is paid within twelve months of the taxable year of disposition.

An "investment asset" is for this purpose:

(i) any *single* asset, other than an investment fund or similar entity;

(ii) acquired *directly* by the fund;

(iii) with respect to which the fund and any related person does not participate in active management of the asset (or if the asset is an entity, active management of the activities of the entity); and

(iv) an asset for which substantially all of the gain on disposition (other than the deferred compensation) is allocated to investors in the fund.

There are a number of items to note about the "investment asset" exception that may significantly limit its utility for many hedge funds, at least as they are currently structured:

- It does not apply until the issuance of regulations

- It applies only to compensation based *solely* on the disposition of an investment asset.

    - It clearly does not apply to the extent that the compensation may be offset by losses on other assets, which may be the case to the extent the side pocket is subject to a high water mark requirement.[12]

    - It applies only to single assets and not multiple assets, and it is not clear whether any sort of mass asset concept (*e.g.*, a pool of loans or receivables being treated as a single "asset") may apply.

    - If "solely based on gains from disposition" is to be read literally, it would disqualify any compensation arrangement that includes current income (*e.g.*, dividends, interest, royalties, rents) in the determination of the incentive amount.

    - It is not clear whether the investment asset exception is determined in the abstract (*e.g.*, whether it is *possible* under the terms of the side pocket for a high water mark to be relevant or for current income on the side pocket to be taken into account), or based on the actual computation (*e.g.*, was the compensation in fact affected by current income).

- It does not apply if there is active management of the underlying investment by the service provider or its affiliates (other than the decision to purchase or sell the investment). Although the election of a director or other exercise of shareholder voting rights would not be treated as active management for this purpose, it excludes (according to the JCT Explanation) any " active participation in the management of the entity." In the context of private equity funds or similar funds, it is

12 The JCT Technical Explanation contains the example of an investment fund that acquires the XYZ operating corporation. The "investment asset" exception is intended to apply to an arrangement pursuant to which the fund manager receives 20 percent of the gain from the disposition of XYZ operating corporation if the fund manager does not actively participate in the management of XYZ operating corporation. By contrast, the rule does not apply if the fund holds two or more operating corporations and the fund manager's compensation is based on the net gain resulting from the disposition of the operating corporations.

unclear whether merely having a "management rights letter" of the sort entered into for VCOC purposes, or exercising the (ordinarily passive) rights provided by such a letter, would violate this requirement. We hope that guidance will clarify that this requirement is not violated merely because the rights are direct contractual rights and not shareholder rights.

- Although the scope of an "indirect" acquisition is not entirely clear, it may exclude any investment made through a blocker corporation, and likely could be read to cover a wide range of other investments, such as "private investment in public equity" or "PIPE" deals done through a vehicle with members of a consortium. Presumably the "direct acquisition" requirement is not intended to exclude investments that are merely made, together with an onshore fund, through a master feeder vehicle, but certainty on the point will require regulatory clarification.

Next Steps:

With respect to deferred fee arrangements outside the context of a side pocket, hedge fund managers will need to amend any pre-2009 deferral arrangements (within the time period specified in regulations to be issued) to be paid by 12/31/2017 or the date there is no longer a substantial risk of forfeiture, if later. They will also need to ensure that no fees for 2009 and subsequent service periods are deferred for longer than twelve months from the end of the taxable year of the service recipient in which there is no longer a substantial risk of forfeiture.

With respect to side pockets, however, it generally will be impossible to provide for payments of fees at the time the side pocket is set up. Hedge fund managers will therefore need to consider the following as a means of avoiding the application of section 457A:

- Confirm that incentive fees or management fees with respect to the side pocket investment are contingent upon the manager's continued provision of services through the date of disposition (*i.e.*, that the fees are subject to a substantial risk of forfeiture under section 457A's narrower formulation); or

- Confirm that the side pocket arrangements qualify under the "investment asset" exception; or

- Hold side pocket assets through a "mini-master" structure in which the assets are held in a partnership and the hedge fund manager or an affiliate receives a partnership distributive share of gain (in effect, a partnership carried interest).

III. ANALYSIS OF SECTION 457A LEGISLATIVE LANGUAGE.

A. Nonqualified Entity

1. Foreign Corporation

A foreign corporation is a nonqualified entity unless substantially all of its income is (i) effectively connected with the conduct of a trade or business in the United States ("ECI") or (ii) is subject to a comprehensive foreign income tax.

"Substantially All of its Income"

The provision does not define the meaning of "substantially all" in this context. Presumably it is something greater than 50%, but beyond that the numerical threshold is uncertain, as is whether it looks to net income, gross income or both.[13] In addition it is also not clear *when* the "substantially all" determination needs to be made – at the time that the deferred compensation arrangement is entered into or the time there is no longer a substantial risk of forfeiture. Whether or not an entity meets the "substantially all" threshold may change over time. For example, a foreign corporation that generates significant ECI in one year (sufficient to meet the "substantially all" requirement) may generate less ECI in a later year or generate additional non-U.S. income. If the status of an entity as a nonqualified entity is to be determined after the compensation arrangement is entered into, a taxpayer may not know whether or not the arrangement will be subject to section 457A. (Section 457A separately provides that compensation that would have been deductible against a foreign corporation's ECI had it been paid in cash will not be subject to section 457A. This provision very clearly applies solely at the time there is no longer any substantial risk of forfeiture.)

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[13] In ruling guidelines in the context of tax-free reorganizations under section 368, "substantially all" has been interpreted to mean 90 percent of an entity's net income and 70 percent of gross income. *See* Rev. Proc. 77-37, 1977-2 C.B. 586.

While the statute requires that the entity either earn income that is ECI "or" be subject to comprehensive foreign income tax, presumably a combination of income that is ECI and of income that is subject to comprehensive foreign income tax ought to be acceptable, provided it amounts to "substantially all" of the entity's income.

Comprehensive Foreign Income Tax

"Comprehensive foreign income tax" means, with respect to a foreign person, the income tax of a foreign country if (i) the person is eligible for the benefits of a "comprehensive income tax treaty" between the foreign country and the United States, or (ii) the person otherwise demonstrates to the satisfaction of the Secretary that the foreign country has a "comprehensive income tax."

The statute does not define the terms "comprehensive income tax treaty" or "comprehensive income tax." Until further guidance is issued, it will be unclear whether all U.S. tax treaties currently in effect can automatically be considered to be "comprehensive income tax treaties."[14] The United States has currently income tax treaties in effect with the following countries: Australia, Austria, Bangladesh, Barbados, Belgium, Canada, China (but not including Hong Kong), Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakhstan, Korea (R.O.K.), Latvia, Lithuania, Luxembourg, Mexico, Morocco, Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, South Africa, USSR (with respect to certain former Soviet Republics), Spain, Sri Lanka, Sweden, Switzerland, Thailand, Trinidad and Tobago, Tunisia, Turkey, Ukraine, United Kingdom and Venezuela.

Even if a foreign corporation's income is subject to tax in a foreign country that has entered into a "comprehensive income tax treaty" with the United States, the foreign corporation will presumably not be considered to meet the test unless it qualifies for treaty benefits under the relevant "limitation on benefits" provisions of such treaty.[15] It is also

[14] The term "comprehensive income tax treaty" is also used in the Code in the context of whether dividends received by individuals from certain foreign corporations qualify for reduced capital gains rates. *See* section 1(h)(11)(C)(i)(II), which defines a "qualified foreign corporation" as a "foreign corporation that is eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this provision and which includes an exchange of information program." Under guidance issued by the IRS, except for U.S. tax treaties entered into with Bermuda, the Netherlands Antilles and the USSR, treaties entered into with the countries listed in the text above are all considered to constitute "comprehensive income tax treaties." *See* Notice 2003-69, 2003-2 C.B. 851, *amplified and superseded by* Notice 2006-101, 2006-47 I.R.B. 930. Because the focus of section 1(h)(11) appears to be on the existence of an exchange of information program, it is not certain whether the list issued pursuant to this section would be the same as a list issued for purposes of section 457A.

[15] U.S. tax treaty benefits are generally available only to residents of a contracting state, which generally includes, in the case of corporations, corporations that are incorporated in the contracting state (or under certain treaties, corporations that are managed and controlled therein). Accordingly, if there were no further limitation on the definition of "resident" or other treaty-shopping limitations, a foreign person could obtain tax treaty benefits available merely by forming a corporation or similar entity that is considered to be a resident of a contracting state that is a party to a favorable tax treaty.

unclear whether failing to meet the requirements of a "limitation on benefits" clause that restricts certain benefits (*e.g.*, reduced withholding taxes) but not all benefits under a tax treaty would lead to a service recipient being treated as not subject to a comprehensive foreign income tax.

While the statute does not require that the foreign corporation is actually subject to tax in the foreign country (so long as it qualifies for the benefits of a comprehensive income tax treaty or its jurisdiction of residence has a comprehensive income tax), the JCT Technical Explanation states that guidance may be issued regarding the application of the "comprehensive foreign income tax" requirement to corporations that are resident in a tax treaty country that has a territorial taxation regime.[16] These are jurisdictions that generally tax only income derived within their borders (*i.e.*, domestic source income and not foreign source income), regardless of the residence of the taxpayer. Few jurisdictions have adopted a pure territorial taxation regime.[17] The JCT Technical Explanation does not define what is meant by a "territorial system." Many European jurisdictions (*e.g.*, Luxembourg, Netherlands, Belgium, Spain) have a worldwide taxation system in that they tax their residents on their worldwide income, but provide for broad exemptions from tax for foreign source dividends or capital gains pursuant to participation exemptions. The example in the JCT Technical Explanation makes it unclear whether jurisdictions with broad participation exemptions may be considered "territorial regimes" for purposes of this guidance with the result that they may be potentially disqualified even if they are parties to "comprehensive income tax treaties" with the United States.

Foreign corporations subject to tax in countries that have not entered into tax treaties with the United States (*e.g.*, Hong Kong, Singapore, UAE, Brazil) will need to establish to the satisfaction of the Secretary that such jurisdictions have a "comprehensive

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The "limitation on benefits" clauses of U.S. tax treaties prevent such treaty shopping by imposing additional requirements that a resident of a contracting state must meet in order to be entitled to the benefits of the treaty.

16 The guidance would address whether or when substantially all the income of such a corporation would be considered to be subject to a comprehensive income tax if the corporation derives income not only from its country of residence but also from one or more countries that may or may not have tax treaties with the United States.

17 Unlike in a worldwide tax system, in a territorial tax system foreign source income earned by a resident is exempt from tax. There is therefore no need for foreign tax credits (because there is no possibility of double taxation) or anti-deferral regimes (because foreign income is exempt from tax). As a practical matter, however, countries that have adopted territorial-type tax systems generally have included exceptions to the territorial principle for certain cases deemed to be abusive, using regimes similar to the U.S. anti-deferral rules and foreign tax credit. For example, France is one of the few jurisdictions that has such a (non-pure) territorial tax regime.

income tax." It remains to be seen whether the Secretary will issue a list of countries that meet such requirement, or a blanket rule (*e.g.*, countries with corporate tax rates in excess of 90% of the U.S. rate) or whether taxpayers will need to get rulings on a company-by-company basis.

Controlled Group Aggregation

Under section 409A, a controlled group of companies (as defined in sections 414(b) and (c) – the simplest example of which is a group of corporations owned 80% by a parent corporation) is treated as a single employer. This is relevant in the section 409A context in determining when there is a nonqualified deferred compensation "plan," when a service provider is treated as an independent contractor, and a number of other concepts that may not be as relevant in the section 457A context. Guidance will be necessary to clarify the relevance of the controlled group rules to section 457A, because the policy behind aggregation is unclear. The JCT Technical Explanation clarifies that these rules will not subject a nonqualified deferred compensation plan of a qualified entity to section 457A merely because the corporation is aggregated with a nonqualified entity, to the extent deferred compensation expense is "properly allocable" to the corporation. Presumably the precise application of these concepts will be clarified in forthcoming regulations.

Examples

- A U.S. executive works for a Singapore corporation that is a nonqualified entity. He is granted vested SARs exercisable more than twelve months from grant.
    - The grant of SARs is subject to section 457A and is immediately taxable on the date of grant if the amount is then determinable. If the amount is not determinable on the date of grant, then it is taxable when it becomes determinable (presumably on exercise) and is then subject to income tax plus interest from the date of grant plus the 20% additional penalty tax.
- In year 1, a Bermuda corporation generates substantially all of its income from a U.S. insurance business, which is taxed as ECI. A U.S. employee is issued SARS that vest in year 3. In year 3 the Bermuda corporation sells a subsidiary and generates a substantial capital gain that is not treated as ECI.
    - It is unclear whether the Bermuda corporation is a nonqualified entity for purposes of evaluating this SAR grant

because the relevant time for the "substantially all" determination remains uncertain.

- A Hong Kong parent corporation owns a Chinese subsidiary. (Assume the Chinese subsidiary is treated as subject to a comprehensive foreign income tax.) A U.S. individual works for the Chinese subsidiary and is entitled to a deferred cash payment.

    - Assuming guidance confirms the JCT Technical Explanation, this should not be subject to section 457A to the extent the compensation expense is "properly allocable" to the Chinese subsidiary. If both corporations employed the U.S. individual the "proper allocation" of the compensation expense to the Chinese corporation might be uncertain.

    - Additional issues may arise if the individual is entitled to nonqualified deferred compensation from the Chinese subsidiary, and (non-deferred) cash payments from the Hong Kong parent – is this respected in accordance with its form, or does it depend on whether it is respected for purposes of Hong Kong and Chinese tax law, or are these compensation arrangements aggregated and a portion of the nonqualified deferred compensation is treated as allocable to the services performed for the Hong Kong parent?

- A Luxembourg corporation has employed a U.S. individual that is entitled to deferred cash payments.

    - It is unclear whether section 457A requires the Luxembourg corporation to satisfy the limitation on benefits clause in the U.S. – Luxembourg treaty. It is also uncertain whether this is judged at the inception of the compensation arrangement or at the time there is no longer a substantial risk of forfeiture. Regulations may also exclude a foreign corporation with a territorial tax system or, potentially, broad participation exemptions.

- A United States corporation owns a Singapore manufacturing subsidiary. The Singapore subsidiary enters into a deferred compensation arrangement with an employee that would be subject to section 457A if the Singapore corporation is a nonqualified entity.

- Section 457A does not have an exception for controlled foreign corporations, even if the U.S. parent corporation is not entirely tax indifferent due to the application of the CFC rules. (Similarly, there is no exemption for a passive foreign investment corporation, whether or not a QEF election has been made). This arrangement may or may not be subject to section 457A, depending on how the controlled group rules are applied in this situation.

- An Abu-Dhabi citizen owns a U.K. corporation that enters into a deferred compensation arrangement with a U.S. person. The U.K. corporation does not have any ECI or its ECI does not amount to "substantially all" of its income.

  - This arrangement may or may not be subject to section 457A, depending on whether substantially all of the U.K. corporation's income is considered to be subject to a comprehensive foreign income tax. It is unclear whether failing to meet the limitation of benefits clause under the U.S.-U.K. treaty, which may be the case where the U.K. corporation is owned by a non-qualified resident (unless the U.K. corporation is engaged in a trade or business in the U.K.), turns the corporation into a nonqualified entity. Presumably the U.K. corporation would be treated by the IRS as subject to a comprehensive income tax (even if the corporation is not an eligible treaty resident), but the timing and method for this determination cannot be predicted.

2. <u>Partnerships</u>

A partnership (whether foreign or domestic) will be a nonqualified entity, unless substantially all of its income is allocated to persons other than (i) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax (defined above) and (ii) tax-exempt organizations. Consequently, for a partnership to not be a nonqualified entity, substantially all of its income must be allocated to U.S. taxable persons or foreign persons subject to comprehensive foreign income tax.

"Substantially All of its Income"

As with foreign corporations, here too the statute is unclear as to the meaning of the term "substantially all," and as to when the "substantially all" test is measured. In the context of a partnership in which allocations may vary over time or with varying types of partnership interests, it may be particularly difficult to determine whether the substantially all test is met. Future guidance must also clarify whether the relevant allocations are with respect to taxable income or book income (and if so, gross income or net income), whether section 704(c) and other regulatory allocations are relevant, the effect of section 743 adjustments, and whether guaranteed payments are treated as allocations for this purpose.[18]

Effectively Connected Income and UBTI – Operating Partnerships

The prior House version of section 457A provided that a partnership would not be treated as a nonqualified entity if substantially all of its income were allocated to persons that included (i) U.S. taxable persons, (ii) foreign persons subject to a comprehensive foreign income tax, (iii) foreign persons with respect to which any allocated income is treated as ECI and as to which withholding tax was paid under section 1446, and (iv) tax-exempt organizations with respect to which any allocated income is taxable as unrelated business taxable income ("UBTI"). As noted above, the final version of the statute does not include foreign and tax-exempt partners subject to ECI and UBTI, respectively, as persons to whom income can be allocated without counting adversely in the determination of nonqualified entity status. The JCT Technical Explanation describes the provisions of the House bill and states that these latter situations will also be excluded. Unless clarified by regulations or a technical corrections bill to be consistent with the JCT Technical Explanation, the statute suggests that a performance fee paid by a foreign corporation substantially all of the income of which is ECI would escape the application of section 457A, while the same fee paid by a partnership owned by foreign (or tax-exempt) partners would not, even if substantially all of the income of the partnership were ECI (or UBTI) that in fact is taxable income when allocated to the partners. This could have some surprising results. Note that although compensation that would be deductible against ECI for a foreign corporation is not treated as nonqualified deferred compensation, there is no similar rule for income generated by a partnership that is taxable in the hands of its partners, whether U.S. or foreign.

Examples

- A U.S. private equity fund with substantial foreign and tax-exempt limited partners owns interests in an operating partnership with all of its

[18] Based on the policy of section 457A, it would have been more logical for the nonqualified entity definition to relate to the allocation of gross compensation expense. This would properly (in our view) have disregarded the potential allocation effects of a guaranteed payment or preferred partnership interest, section 704(c) methodology, section 743 adjustments and other technicalities that seem to be unrelated to ensuring that (direct or indirect) employers are not tax indifferent as to the timing of deductions.

business in the United States. All of the income generated by the partnership is ECI and UBTI.

- Under the current statute, the operating partnership would be a nonqualified entity, and nonqualified deferred compensation paid to service providers might be subject to section 457A. Under the prior House bill and the JCT Technical Explanation, the entity described above would not have been a nonqualified entity.

- Same example as above, except the operating partnership also owns some assets that do not generate ECI.
  - Allocations of such non-ECI income to foreign limited partners would count adversely in the determination of nonqualified entity status, and the operating partnership might be a nonqualified entity even under the JCT Explanation.

- A Swiss and U.S. pharmaceutical corporation form a 50/50 joint venture treated as a partnership for U.S. tax purposes to perform certain research and development activities in the United States. The joint venture's income is treated as ECI with respect to the Swiss pharmaceutical corporation.
  - Based on the wording of the current statute, the joint venture would be a nonqualified entity (despite the fact that the Swiss partner will be subject to U.S. net income tax with respect to its distributive share of the joint venture's income) unless the Swiss pharmaceutical corporation is considered to be subject to a comprehensive foreign income tax. Until further guidance is issued, it may be unclear whether the Swiss corporation is treated as subject to a comprehensive foreign income tax, for example due to an exclusion of jurisdictions with a participation exemption, or application of a limitation on benefits clause.

- A publicly traded master limited partnership ("MLP") does not have perfect knowledge of its beneficial owners.
  - It is unclear whether it is a nonqualified entity – how would the MLP establish that all of its income was allocable to U.S. persons, foreign persons subject to a comprehensive foreign

> income tax or section 1446 withholding, or U.S. tax-exempts subject to UBTI? Suppose significant shares are owned by a state pension plan exempt under section 115 (*i.e.*, not subject to UBTI)?

Compliance Issues

The nonqualified entity test presupposes that a service provider has knowledge of the income allocations of the partnership entity. This may not always be the case. Moreover, since indirect allocations (*i.e.*, through upper tier pass-through entities) also will need to be taken into account in this determination, the service provider and the lower-tier partnership providing the compensation must have knowledge of the upper-tier income allocations, which may not be available information. Even if the identity of the persons receiving the income allocations and the manner of such allocations are known, the service provider will require information as to whether such persons meet the "comprehensive foreign income tax" requirement (*e.g.*, eligibility for benefits under a comprehensive income tax treaty).

B. <u>Nonqualified Deferred Compensation Plan</u>

1. <u>Deferred Compensation Plans Subject to Section 457A</u>

For purposes of section 457A, a "nonqualified deferred compensation plan" has the same meaning as under section 409A(d), plus it also includes any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units.[19] Accordingly, unlike section 409A, section 457A would apply to stock appreciation rights (SARs) (including, possibly, stock-settled SARs) without regard to whether they meet the requirements to be exempt from section 409A (which include having an exercise price

[19] Because section 457A defines "nonqualified deferred compensation plan" by reference to section 409A (and, implicitly, the regulations under section 409A), the concepts of "deferred compensation" and a "plan" of deferred compensation ought to be consistent in the absence of overriding section 457A guidance. It is reasonable to conclude that this includes the section 409A exception for "short term deferrals." Although an argument may be made that this means that *any* compensatory payment that is excluded from section 409A as a result of the short term deferral rule will also be exempt from section 457A, we do not believe this is the intention of the legislation or a correct reading of the provision. As an interpretive matter, even though a payment may be excluded as a short term deferral if paid within 2 ½ months of the end of the taxable year in which there is no longer a "substantial risk of forfeiture," the definition of "substantial risk of forfeiture" for section 457A purposes is narrower and we do not believe that the cross reference to section 409A(d) was intended to import the broader definition into the short term deferral analysis. In addition, if any payment exempt under section 409A as a short term deferral were excluded, that would largely negate the (narrowly drafted) investment asset exclusion, which would be a surprising result.

equal to fair market value on the grant date and being based on "service recipient stock" within the meaning of section 409A). Consequently, SARs that pass muster under section 409A may run afoul of new section 457A, and SARs may be treated significantly differently than options even though they are economically equivalent forms of compensation.

Section 457A is not intended to apply to transfers of property to which section 83 applies (*e.g.*, grant of an at-the-money option or transfer of restricted stock), provided the compensation arrangements do not include a deferral feature other than the right to exercise the option in the future. The JCT Technical Explanation also states that section 457A cannot be avoided through the use of an instrument such as an option or a notional principal contract held or entered into directly or indirectly by the service provider, the value of which is determined in whole or part by reference to the profits or value (or any increase or decrease in the profits or value) of the business of the entity for which the services are effectively provided, particularly when the value of such instrument is not determinable at the time it is granted or received. The scope of this anti-abuse rule is not yet known.

Section 457A does not cover the receipt of partnership capital or profits interests (which are currently also not captured by section 409A pending issuance of regulations).[20] Guaranteed payments by a partnership, however, *may* be treated as deferred compensation subject to section 409A and, by cross-reference, may be subject to section 457A.[21] Guaranteed payments for services may arise in a variety of circumstances where a partnership distribution or capital account is received "without regard for partnership income" – a concept that is not clearly delineated in guidance. It may include payments related to retirement from a partnership under section 736, or payments that do not correspond with a partnership's income (*e.g.*, performance, even negative performance, to the extent it exceeds an S&P index return), or a variety of other arrangements that are related to partnership performance but are treated technically as being "without regard for partnership income." Although this same issue existed in evaluating the effect of section 409A, section 457A may apply in situations where section 409A clearly does not apply or, if applicable, would not be violated (*e.g.*, an accrual basis service provider, a fixed payment schedule, or a substantial risk of forfeiture for the entitlement based on the occurrence of a condition related to the purpose of the compensation).

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[20] This result may change if the section 409A regulations are amended to include partnership interests within their scope. Similarly, if compensatory partnership legislation is passed (*e.g.*, new section 710), the issuance of compensatory partnership interests or receipt of a distributive share of income on account of services may fall within the scope of section 409A and section 457A.

[21] *See* Preamble to Final Regulations under section 409A, TD 9321, 72 Fed. Reg. 19243.

2. Accrual Method Service Providers

The statutory language of section 457A does not expressly provide whether it applies solely to cash basis method service providers or also to accrual method service providers. The prior House bill had expressly provided that it applied without regard to the method of accounting of the service provider. Consistent with the House bill, the JCT Technical Explanation states that section 457A *will* apply to accrual method service providers, unlike section 409A. Presumably the rationale for having section 457A apply to all service providers is that, if it did not, an accrual method service provider might well recognize income later than a cash method service provider (if the "all events" test was not met at the time there was no substantial risk of forfeiture) and/or avoid penalty taxes.

If the JCT Technical Explanation is correct in the manner in which it applies section 457A, as actually enacted, to accrual method taxpayers, it would potentially mean a change to the application of the established "all events" test. Under this test, an amount is taken into account for tax purposes in the taxable year in which all events have occurred that fix the right to compensation and the amount thereof can be determined with reasonable accuracy. For the second prong of the all events test (*i.e.*, determination with reasonable accuracy), the income accrual generally occurs when there is a reasonable basis (the facts from which the calculation is to be made are known at the end of the tax year) for the calculation of the amount, and subsequent adjustments are then made to the income accrual in the year of actual receipt, as needed. When section 457A applies, by contrast, an accrual method taxpayer may be forced to include income prior to the time there is a legal entitlement because there is a significant condition that does not relate to the performance of services. Even if the timing of the inclusion is the same because section 457A does not require an inclusion until the compensation amount is determinable, the taxpayer might become subject to the 20% penalty and underpayment tax if the amount was not determinable at the time there was no substantial risk of forfeiture.

3. Examples

- A private equity general partner agrees to pay a "finder's fee" to an individual. The finder's fee is payable at the time a carried interest payment is made to the general partner, and is equal to a fixed percentage of the carried interest (in effect, a phantom carried interest).
    - If the general partner is a "nonqualified entity" the phantom carried interest arrangement may be subject to section 457A, *even though* an actual payment of a distributive share of carried interest pursuant to a profits interest would not be (in the absence of an anti-abuse rule).

- U.S. investment bank is the sponsor of a private equity fund organized in the Caymans Islands. Because a significant number of limited partners are residents of jurisdictions without a comprehensive foreign income tax, the fund is a "nonqualified entity." The investment bank receives a carried interest from the fund based on a mark to market valuation (even though the fund is not actually eligible for section 475 mark to market methodology and is not a securities partnership entitled to "book up" capital accounts based on mark to market valuations). Once the investment is made the investment bank is entitled to its carried interest without being required to perform significant services.
    - If this distribution is treated as a guaranteed payment (because it is based on unrealized gains measured based on a mark to market valuation and is not related to partnership tax or book income), it may be taxable to the investment bank when the amount is determinable, subject to a 20% penalty tax and underpayment penalty.
- U.S. bank sponsors a hedge fund founded by ex-employees. The business arrangement is that, in return for being an anchor investor and providing marketing and back office support at formation, the bank is entitled to receive 20% of the gross management fees received by the hedge fund manager. The bank agrees to take this amount in the form of a fee rather than an equity interest (in order not to negatively affect the cash method of accounting of the hedge fund manager under section 448, or for regulatory or accounting reasons).
    - Assuming the back office services are "substantial" services, the entitlement to the fee is subject to a section 457A substantial risk of forfeiture and section 457A does not apply so long as the payment must be made within the twelve month deferral period.
    - If the back office services were not required as a factual matter or were deemed not to be substantial services for purposes of section 457A, then unless the fee arrangement is treated as being in respect of capital (the anchor investment) rather than services, the fee arrangement appears to be subject to section 457A and the bank would be subject to a 20% penalty tax and underpayment penalty, because the amounts to which the bank is entitled are not "determinable". If the arrangement were restructured as a partnership profits interest in the hedge fund

manager rather than a fee arrangement, it appears (absent an anti-abuse rule) to avoid section 457A.

- A U.S. professional partnership is a "nonqualified entity" because a sufficiently large percentage of its income is allocated to foreign persons not resident in jurisdictions with a comprehensive foreign income tax. Partners that have worked at least 15 years are entitled to receive pension payments from the partnership in retirement. The payments are not determined based on partnership income.
  - The pension payments are not in respect of partnership income and will be treated as partnership guaranteed payments under section 736 except to the extent the payments are for partnership capital. Except to the extent such payments are excluded from treatment as nonqualified deferred compensation under section 409A under relevant regulations, these payments appear to be subject to section 457A and are all currently taxable.[22]

4. ECI Exception

Deferred compensation payable by a foreign corporation that is otherwise a nonqualified entity and that is deductible against ECI is excluded from treatment as deferred compensation. The statutory exception appears to require that the foreign corporation have ECI in the year that there is no longer as substantial risk of forfeiture. It is unclear whether or not this exception is intended to apply if the foreign corporation has U.S. operations but is running at a loss (*i.e.*, no net ECI for the taxable year). Presumably the foreign corporation will have to provide information to the service provider establishing the existence of this exception.

[22] There are no currently applicable section 409A regulations dealing with partnership payments to partners. Notice 2005-1, Q&A-7 provided that section 409A would cover payments that fall within section 707(a)(1) (partner not acting in capacity as a partner), and would cover guaranteed payments under section 736 to the extent such payments qualify as exempt from self-employment tax under section 1402(a)(10). The preamble to the final regulations (referring back to the discussion in the preamble to the proposed regulations), excludes guaranteed payments under section 707(c) to the extent they are included in income by the service providing partner by the 15th day of the third month after the end of the taxable year in which there is a legal entitlement to the payments or, if later, there is a substantial risk of forfeiture (basically, a short term deferral exception). This framework for section 707(c) payments may be less forgiving in the section 457A context than it is for section 409A because of the narrower definition of a substantial risk of forfeiture.

No similar exception is provided for partnerships, so if a partnership is a nonqualified entity, even if all of a partnership's income is allocable to U.S. partners, foreign partners subject to tax on ECI, and tax-exempt partners subject to tax on UBTI, the deferred compensation may be subject to section 457A. This would be a perverse result and it would be consistent with the intent of the statute that, to the extent deductions for deferred compensation expenses are allocable to U.S. taxpayers (*i.e.*, U.S. persons, foreign persons subject to a comprehensive income tax, or tax-exempt persons subject to tax on UBTI), such deferred compensation should be excluded from section 457A.

C. Determinability

If the amount under the deferred compensation plan to which the service provider is entitled is determinable at the time it is no longer subject to a substantial risk of forfeiture, it is taxable at such time. If it is not determinable at that time, it is includable in income once it is determinable, subject to the additional 20% penalty tax and imputed interest. The statute contains no definition of the term "determinable." Since whether an amount is determinable at the time the section 457A substantial risk of forfeiture lapses has such a drastic cliff effect, there may be considerable pressure to conclude that an amount is determinable and/or avoid compensation arrangements in which there is doubt as to whether an amount is determinable.

Presumably this concept of determinability is intended to cover performance fees tied to asset appreciation. Based on the JCT Technical Explanation, we expect that regulations will be issued regarding when an amount is not determinable for purposes of the provision, and providing that an amount is not determinable if it varies depending on the satisfaction of an objective condition.[23]

There may be circumstances, however, in which it is not clear whether an amount is determinable for purposes of section 457A (*e.g.*, where an employee of a foreign nonqualified entity is promised a fixed amount of deferred salary over a number of years but denominated in a foreign currency, or where an amount is subject to a remote or small contingency). Presumably restricted stock units ("RSUs") would be treated as having a "determinable" value at the time of vesting since the value of the RSU at the time of vesting is clearly equal to the value of the stock to which it relates, and we hope that future guidance will confirm this point.

One circumstance that may arise in many situations is where an employee is entitled to a fixed amount, plus an investment return. While there may be an issue as to

23 The JCT Technical Explanation contains the example of a deferred amount that is only paid if a certain threshold is met and where the amount being paid varies depending on the threshold level that is achieved.

whether the final payment amount would be determinable, section 457A also includes by cross-reference rules similar to those provided in section 409A(d)(5), which states that references to "deferred compensation" include earnings (actual or notional) attributable to the compensation. Under the section 409A regulations, earnings may be treated as separate items of deferred compensation. Assuming a similar rule applies for purposes of section 457A, it may allow earnings (while taxed currently) to avoid being subject to penalty taxes.

D. Substantial Risk of Forfeiture

A person's rights to compensation are treated as subject to a substantial risk of forfeiture only if the rights to compensation are conditioned upon the future performance of substantial services by any individual.

As noted above, section 457A defines "substantial risk of forfeiture" with substantially the same statutory language as used in section 409A, but not by cross-reference. The definition of substantial risk of forfeiture for purposes of section 409A has been expanded under the section 409A regulations to include entitlements conditioned on the occurrence of a condition related to the purpose of the compensation (*i.e.*, a contingency based on a business goal of the service recipient). For purposes of section 457A, "substantial risk of forfeiture" will *not* (according to the JCT Technical Explanation) include such conditions even if the possibility of the risk of forfeiture is substantial. Consequently, section 457A may apply even where significant contingencies remain. Because it is very likely that the amounts to be received are not determinable at the time there is no substantial risk of forfeiture, such arrangements will result in the application of the 20% penalty tax and interest charge.

As described in detail under Part II above, there is a limited exception for compensation that is determined solely by reference to the amount of gain recognized on the disposition of an investment asset. While we assume this provision was enacted with the intent to apply to typical side pocket arrangements, due to its restrictive conditions, its scope of application will likely be limited.

E. Transition Rules and Permissible Plan Amendments

Section 457A applies to amounts deferred which are attributable to services performed after December 31, 2008. Amounts deferred that relate to services performed prior to December 31, 2008 are subject to a limited grandfather exception and can be deferred up to and including the last taxable year beginning before 2018 (or, if later, the date on which there is no substantial risk of forfeiture). Earnings on amounts deferred which are attributable to services performed on or before December 31, 2008 are subject to section 457A only to the extent that the amounts to which such earnings relate are subject to the provision. H.R. 1424 provides that regulations will be issued permitting (without violation of section 409A) an amendment of a deferred compensation plan to accelerate payment of amounts attributable to pre-2009 services to the date on which the amounts must be included in income.

A few items to note:

- The statute indicates that there will be only a limited time period during which plans can be amended to comply with section 457A, without triggering section 409A. The guidance addressing these permissible amendments needs to be issued within 120 days from the effective date of section 457A. The statute does not provide, however, what the limited time period will be. Consequently, any service provider that has currently deferred payments beyond December 31, 2017 should consider amending the arrangement as soon as possible. Although section 457A will not require an income inclusion prior to 2018, the income inclusion at that time would be subject to section 457A and, if not determinable, subject to the penalty tax and an underpayment penalty. This may also include compensation arrangements with service recipients that are not currently nonqualified entities, but which may be in subsequent years at the time there is no longer a section 457A substantial risk of forfeiture.

- The amendment provision narrowly permits an amendment to accelerate the timing of distributions and does not cover amendments more broadly, including those that might separate base deferred compensation and earnings on the deferred amounts, those that conform the compensation plan to the narrower definition of "substantial risk of forfeiture" etc. Accordingly, any broader changes should be implemented before the end of 2008 (so as to not run afoul of section 409A) on the assumption that the scope of permissible amendments pursuant to the to-be issued guidance (which are considered not to violate section 409A) is limited.

F. Ancillary Effects on Service Providers and Recipients

- Because a service recipient is permitted to take a compensation deduction at the time that an employee takes deferred compensation into income, the application of section 457A may accelerate deductions, including for a partnership that is a nonqualified entity but has some (perhaps many) U.S. taxable partners.

- Any such accelerated deduction is a non-cash expense that may exceed the economic burden actually borne by U.S. partners of a partnership (*i.e.*, because the income inclusion does not take into account the net present value of the deferred income or a discount for substantial contingencies unrelated to continuing services). Treasury may need to issue guidance regarding the allocation of compensation expense among partners where the allocation does not appear to have a substantial economic effect.

- It would not be surprising if the Treasury issued anti-abuse rules to avoid the inappropriate use of these sorts of arrangements. If section 457A were amended to apply solely to the extent the compensation expense deductions were allocated to non-U.S. taxpaying partners, this would reduce the scope of the anti-abuse issue.

- It is clearly possible for a service provider to include compensatory income under section 457A that ultimately is not paid. It is not clear if the service provider would be entitled to a deduction in the year of forfeiture, or would be entitled to amend his or her tax return, or whether section 1341 would apply.[24] It is also not clear whether (under new guidance or under general principles) the service recipient would be required to include income to offset the prior deduction. In the context of a partnership, this income might or might not be allocated to partners that had been allocated the prior deduction.

Questions regarding this memorandum or the application of section 457A may be directed to Bob Raymond, Jason Factor or any of our other partners or counsel in New York listed under Tax or Employee Benefits in the "Practices—Areas of Law" section of our website (http://www.clearygottlieb.com).

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[24] Section 1341 would not appear to be applicable because service providers that remain subject to a risk of forfeiture (including one that does not constitute a “substantial risk of forfeiture” for purposes of section 457A) do not have an unrestricted right to the compensation.

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