Client Alert

pillsbury

Executive Compensation & Benefits | Tax

January 29, 2009

IRS Gives Guidance on Deferred Compensation from Offshore Funds

by Timothy Burns, Mark C. Jones and Kathleen Bardunias

On January 8, the Internal Revenue Service (IRS) issued preliminary guidance on the taxation of deferred compensation from offshore investment partnerships and other tax-indifferent entities. Notice 2009-8, which is intended to provide interim guidance under Internal Revenue Code Section 457A until formal regulations are adopted, answers critical questions raised after the initial enactment of Section 457A and affirms that Section 457A is intended to have a wider scope in many respects than the counterpart provision on deferred compensation, Section 409A.

Background

The legislation codified as Section 457A of the Internal Revenue Code was attached to the Emergency Economic Stabilization Act of 2008 (EESA) as a revenue-raising device intended to partially offset the cost of the economic relief programs being enacted. (See Pillsbury Client Alert, "Offshore Deferred Compensation to be Taxable at Time of Vesting," Oct. 21, 2008). Section 457A derived from draft legislation that had intended to render currently taxable, as ordinary income, performance fees and other forms of compensation benefiting U.S. managers of investment funds located in countries with favorable tax regimes. Generally, deferred compensation allocated pursuant to a nonqualified plan is governed by Code Section 409A. Under Section 409A, deferred compensation is not taxed until it is actually or constructively received by the service provider, as long as the service provider has made a timely deferral election and certain requirements under the Code are met.

Section 457A provides rules similar to those set forth in Section 409A to regulate the taxation of deferred compensation provided to U.S. taxpayers by certain partnerships and corporations that would otherwise be considered to be "tax indifferent" entities for the purposes of determining when they recognize income. One key difference with Section 457A is that the IRS will not honor a deferral election with respect to Section 457A income, unlike income that is subject only to Section 409A.

General Rules

Section 457A provides that deferred compensation under a nonqualified plan of a nonqualified entity will be includible in the taxpayer's gross income at the time that the compensation is no longer subject to a substantial risk of forfeiture. Section 457A generally applies to the same plans and taxpayers as Section 409A, except that Section 457A specifically applies to stock appreciation rights and certain other equity units excluded from the scope of Section 409A. Notice 2009-8 adds a number of additional differences. Most significantly, Notice 2009-8 clarifies that accrual-basis taxpayers are included in Section 457A and carves out from its scope stock appreciation rights that must be settled in stock of the service recipient. Notice 2009-8 also provides that the receipt of a profits interest in a partnership will be treated substantially the same as under the existing guidance under Section 409A (which does not generally treat as a deferral of income the receipt of a profits interest not otherwise required to be included in income). Accordingly, investment funds structured to use profits interests (e.g., carried interest allocations) in lieu of performance fees should generally not have a different result with respect to such items under Section 457A than under existing Section 409A.

Section 457A defines a "nonqualified entity" as:

1) any foreign corporation unless substantially all of its income is

   (A) effectively connected with the conduct of a trade or business in the United States, or

   (B) subject to a comprehensive foreign income tax, and

2) any partnership unless substantially all of its income is allocated to persons other than –

   (A) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and

   (B) organizations which are exempt from tax under this title.

Notice 2009-8 provides that the first prong of this test is met if 80 percent or more of the corporation's gross income is effectively connected with the conduct of a U.S. trade or business. For all other foreign corporations, Notice 2009-8 sets out a three-part test:

1) The corporation must be subject to a comprehensive tax treaty with the United States (excluding the treaties with Bermuda and the Netherlands Antilles);

2) The corporation must not be taxed by its country of residence under a regime that is materially more favorable than the corporate income tax generally paid by that country. (This provision is intended to exclude certain countries, such as Ireland, that afford preferential tax treatment to distributed interest income); and

3) The corporation must not reside in a country, such as Germany, with a territorial tax regime – that is, a system of taxation that excludes nonresident source income, if such income comprises 20 percent or more of the corporation's total gross income.

Similar rules apply to partnership, and Notice 2009-8 sets forth specific rules on the allocation of income among partners for this purpose, including rules for determining allocations in the context of tiered ownership structures. In general, the tiered ownership rules focus on whether a particular item of income is taken into account under the laws of the jurisdiction of the foreign indirect owner other than under an anti-deferral regime (such as the controlled foreign corporation or passive foreign investment company rules or analogous non-U.S. provisions). As a practical matter, it may be difficult to determine whether a partnership is a nonqualified entity where entities in multiple foreign countries hold the partnership interests or where a tiered ownership structure is involved.

A corporation is determined to be a nonqualified entity by applying the above analysis as of the last day of the service provider's taxable year. The analysis of a partnership is based on the allocations for the partnership's tax year ending with or within the service provider's taxable year. Therefore, Section 457A applies to all compensation that vests over the year (or in a prior year, to the extent not previously taken into income) if the service recipient becomes a nonqualified entity at any time during the year and is deemed to be a nonqualified entity on the last day of the plan sponsor's taxable year.

Under Section 457A, compensation is subject to a substantial risk of forfeiture only if the taxpayer's right to the compensation is conditioned on his or her future service. Notice 2009-8 clarifies that stock rights and other rights to compensation that are conditioned on a particular growth benchmark will not be considered as subject to a substantial risk of forfeiture.

Section 457A sets out one exception to this definition of substantial risk of forfeiture. If the amount of deferred compensation is indeterminable when it vests, then Section 457A allows the taxpayer to defer recognition of the income until it becomes determinable, subject to a 20% additional tax and interest at the underpayment rate plus 1%. Notice 2009-8 provides that a deferred amount will be treated as not determinable only if it would be treated as a "formula amount" under the proposed calculation regulations under Section 409A. These regulations set forth a narrow "indeterminability" exception for bonuses tied to future profits and similar payments based on amounts that remain variable until a particular date. Subject to the discussion above relating to the treatment of profits interests, investment funds that have not historically tried to defer performance fees, but which provide for "sidepocket" investments, may want to consider the impact of Section 457A(d)(1)(B) (which sets out special rules for compensation based solely on the amount of gain recognized on the disposition of an investment asset) and the foregoing provisions of the notice in their own particular situation.

Because Section 457A employs a narrow definition of substantial risk of forfeiture, Notice 2009-8 observes that the exception for short-term deferrals, which is otherwise identical to that of Section 409A, may expire earlier under Section 457A in certain circumstances. Section 457A also has a separate exception for deferred compensation that is paid to the taxpayer no later than 12 months following the close of the service recipient's taxable year in which the deferred compensation vested. While this rule may provide for a longer short-term deferral period than that the Section 409A period, Notice 2009-8 affirms that many forms of deferred compensation that would otherwise be subject to 457A will still have to comply with the narrower short-term deferral exception under Section 409A to avoid taxation under that section.

Notice 2009-8 also clarifies that once a taxpayer has included an amount of Section 457A deferred compensation in gross income, he will not be taxed again on the income at receipt. Earnings on deferred compensation are treated as separate deferrals as long as the amount of the earnings is "reasonable" and the earnings are paid at least annually. Otherwise, the earnings are treated as currently deferred amounts. The notice does not give any guidance on how to determine where earnings are "reasonable."

Effective Date and Transition Rules

Notice 2009-8 provides that Section 457A applies to any deferred compensation that is attributable to services performed by the taxpayer after December 31, 2008. Deferred compensation that would be subject to Section 457A except that it is attributable to services performed prior to January 1, 2009, will be included in gross income in the later of (a) the last taxable year beginning before 2018 or (b) the taxable year in which there is no longer a substantial risk of forfeiture to the amounts deferred.

For purposes of determining whether an amount is grandfathered, amendments made to a plan after December 31, 2008, will generally be disregarded, except that the notice sets out a special transition rule allowing a plan to be amended retroactively to provide that a substantial risk of forfeiture that would otherwise lapse after December 31, 2008, will lapse before January 1, 2009, as long as the amendment is reduced to writing, adopted before July 1, 2009, and applied consistently to every service provider in the same arrangement or any substantially similar arrangement.

Notice 2009-8 provides that inclusion in income of deferred compensation under Section 457A will be treated as a payment exempt from Section 409A pursuant to the short-term deferral rule. Until final regulations are issued, the IRS will treat the inclusion of reasonable earnings under Section 457A, if distributed at least annually, as payments in accordance with a fixed schedule for purposes of Section 409A. Transition rules are in effect for 2008 and 2009 so that amendments to bring nonqualified deferred compensation plans into compliance with Section 457A will not have an adverse effect on compliance with Section 409A.

For further information, please contact:

New York

Susan P. Serota (bio)
+1.212.858.1125
susan.serota@pillsburylaw.com

Mark C. Jones (bio)
+1.212.858.1430
mark.jones@pillsburylaw.com

James T. Chudy (bio)
+1.212.858.1116
james.chudy@pillsburylaw.com

Peter J. Hunt (bio)
+1.212.858.1139
peter.hunt@pillsburylaw.com

Harsha Reddy (bio)
+1.212.858.1613
harsha.reddy@pillsburylaw.com

San Francisco

Timothy Burns (bio)
+1.415.983.1541
timothy.burns@pillsburylaw.com

Silicon Valley

C. Brian Wainwright (bio)
+1.650.233.4618
brian.wainwright@pillsburylaw.com

Washington, DC

Brian M. Blum (bio)
+1.202.663.8389
brian.blum@pillsburylaw.com