

Treasury Issues Guidance on New Section 457A More Compliance Headaches for Deferred Compensation Arrangements

Miller & Chevalier

A Washington law firm specializing in counseling and dispute resolution in the areas of

- Tax
- Employee Benefits
- International
- Litigation
- Government Affairs

We help our clients resolve controversies at all levels of the federal court system and within the federal agencies. From Washington, we serve clients across the United States and around the world.

655 15th Street, N.W.
Suite 900
Washington, D.C. 20005-5701

For more information, please contact us at
202-626-5800 or
visit our website:
www.millerchevalier.com

On January 8, 2009, the Treasury and the IRS released Notice 2009-8 (the "Notice") which provides guidance in question-and-answer format with respect to the application of new section 457A. At first blush, the guidance confirms the original concerns that section 457A is potentially broad in scope (applying to more than just hedge fund deferral arrangements) and that its application will present significant administrative challenges for deferral arrangements covering U.S. taxpayers employed by foreign corporations, including subsidiaries of U.S. corporations, and by partnerships with exempt organization or foreign partners. Section 457A generally applies to deferred amounts that are attributable to services performed in 2009 and afterwards.

As discussed below, a critical factor in determining whether the new provisions will apply to a nonqualified deferral arrangement is whether the foreign corporation maintaining the deferred compensation arrangement is resident in a country that is not a party to a comprehensive income tax treaty with the United States or does not otherwise have a "comprehensive foreign income tax." Perhaps more importantly, the Notice also makes it clear that even if the foreign corporation is resident in a treaty country or a country with a comprehensive foreign income tax, it may nonetheless be treated as a nonqualified entity if the country of residence employs a territorial system for taxing income and if the foreign corporation receives a significant amount of exempt income (including dividends from a lower-tier affiliate resident in another treaty country that exempts some

of the affiliate's income or in another non-treaty country that does not have a "comprehensive foreign income tax"). Accordingly, in some instances it may not be possible to determine whether the deferral arrangement will result in current taxation of covered individuals, except on an after-the-fact basis, and even then the status of the sponsor as being a "nonqualified entity" may not be entirely clear (because it may not be possible to determine without a Treasury pronouncement whether a particular country that is not otherwise a U.S. treaty partner has a "comprehensive foreign income tax").

Further, the treatment of "check-the-box" entities is left unclear by the Notice; it is not clear, for example, whether an arrangement maintained by a disregarded entity is deemed to be maintained by its regarded owner, or whether the income of disregarded entities must be considered in determining whether substantially all of the income of the regarded owner is considered taxed by its country of residence. This could lead not only to uncertainty, but also to possible highly inappropriate results in certain circumstances.

In addition, if a nonqualified deferred compensation arrangement is potentially covered, the new rules make the tax consequences of coverage under certain types of deferral arrangements punitive. Arrangements under which the amount of the deferral is not determinable at time the covered individual's right to compensation vests will trigger additional section 409A-type taxes on the covered

The information contained in this Alert is not intended as legal advice or as an opinion on specific facts. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. For more information about these issues, please contact the author(s) of this Alert or your existing Miller & Chevalier attorney contact. The invitation to contact the Firm and its attorneys is not to be construed as a solicitation for legal work. Any new attorney-client relationship will be confirmed in writing.

This Alert is protected by copyright laws and treaties. You may make a single copy for personal use. You may make copies for others, but not for commercial purposes. If you give a copy to anyone else, it must be in its original, unmodified form, and must include all attributions of authorship, copyright notices and republication notices. Except as described above, it is unlawful to copy, republish, redistribute, and/or alter this Alert without prior written consent of the copyright holder.

individuals, over and above the regular tax on the amount of the current inclusion. Moreover, the provision injects added levels of complexities into the Internal Revenue Code's rules for deferred compensation by not using precisely the same definitions of "deferred compensation" and "substantial risk of forfeiture" as those found in sections 409A and 83. Finally, because the new rules turn on whether the service provider's employer is a "nonqualified entity," the new rules may increase the scrutiny on seconding or loan-out arrangements which are typically used by U.S. multinational companies with expatriate employees. In this connection, the Notice asks for comments on the extent to which a reimbursement arrangement between a domestic service recipient and a nonqualified entity that has agreed to share or reimburse the domestic service recipient's compensation costs should result in the domestic service recipient also being treated as a nonqualified entity.

Overview

In general, section 457A effectively puts individuals who are U.S. taxpayers and are covered by nonqualified deferred compensation arrangements of "nonqualified entities" on an accrual method of accounting for income from the deferral arrangement, whether or not the arrangement otherwise meets section 409A. More specifically, section 457A requires that any compensation that is deferred under a nonqualified deferred compensation plan of a "nonqualified entity" will be includible in a covered service provider's gross income when there is no substantial risk of forfeiture of such amount. In this connection, it should be noted that a nonqualified deferred compensation plan will be treated as the plan of a nonqualified entity (that is, the entity will be treated as sponsoring the plan) if, with respect to any amount deferred under the plan, the entity would

be entitled to a compensation deduction under U.S. tax principles if that amount had been paid in cash to the service provider in that relevant year. Q&A-14. Thus, under this rule, foreign subsidiaries whose employees participate in a U.S. parent's deferred compensation plan will be treated under section 457A as sponsoring such plan with respect to their employees. Moreover, under this rule, it appears that U.S. tax principles, and not local tax or employment law principles, are used to determine whether an individual is an employee of a foreign corporation.

Nonqualified Entities

Under section 457A, a nonqualified entity is (a) a foreign corporation if less than substantially all of its income is effectively connected with a U.S. trade or business (at least 80% must be so connected) or subject to a "comprehensive foreign income tax," or (b) any partnership (either U.S. or foreign) if generally more than 20% of its income is allocated to persons who are (i) foreign persons whose income is not subject to a "comprehensive foreign income tax" or (ii) U.S. tax-exempt organizations. The Notice provides guidance on determining what is a nonqualified entity, but cautions that there may be future guidance, which would apply prospectively, that could expand the definition of such an entity.

Under the Notice, an entity's status as a nonqualified entity is determined as of the last day of the service provider's tax year (which in the case of most employee service providers will be the calendar year) in which the deferred compensation is no longer subject to a substantial risk of forfeiture and remains deferred. Q&A-13. Therefore, deferred compensation may move in or out of coverage by section 457A depending on the entity's status for that year. Presumably, the determination of

the entity's status on the last day of the service provider's tax year is done by evaluating the entity's status for its tax year ending with or within the service provider's tax year, but this is not clear under the guidance. In the case of partnerships, the Notice indicates that the status of the partnership as a nonqualified entity is determined as of the last day of the service provider's tax year, based on the allocations of gross income by the partnership for the partnership's taxable year ending with or within the service provider's taxable year. Q&A-13(b).

Foreign Corporations

For substantially all the income of a foreign corporation to be subject to a comprehensive foreign income tax, two tests have to be met. First, the foreign corporation must (i) be eligible for the benefits of a comprehensive income tax treaty between its residence country and the U.S. (these include all treaties in force as of January 26, 2009, other than the income tax treaties with Bermuda and the Netherlands Antilles), or (ii) demonstrate to the satisfaction of the Treasury that its country of residence has a comprehensive income tax, provided that in either case the corporation is not taxed by the country of residence under a materially more favorable corporate income tax regime than is otherwise imposed generally on resident corporations. Q&A-8(a). Depending on the particular factual context and the particular tax treaty at issue, there may be technical issues involved in determining whether a foreign corporation would be eligible for the benefits of the treaty, particularly in cases where the foreign corporation receives no U.S. source income and has no U.S. activities, and therefore has no need to otherwise determine whether it is entitled to such benefits. It should also be noted that the Notice asks for comments whether and to what extent a limitation on benefits

provision or exchange of information program is relevant to the determination of what is a comprehensive income tax treaty under the section 457A rules.

With regard to the second prong of the first requirement, it is not clear how one goes about demonstrating that a non-treaty country has a comprehensive foreign income tax, and whether the test is general (i.e., a country has a comprehensive income tax system, or does not) or specific to each taxpayer (i.e., a country's income tax system is comprehensive as applied to the taxpayer at issue, or is not). As originally proposed, section 457 focused on whether the foreign country had deduction rules for deferred compensation that were comparable to those under section 404, but how relevant this facet will or should be to the Treasury's determination is uncertain at this point. Further, the relevance of other factors, such as whether a foreign tax is creditable as an income tax under existing section 901 standards, is also unclear.

The second requirement is that not more than 20% of the foreign corporation's income is excluded under the residence country's tax system as nonresidence source income (e.g., the country has a territorial tax system or a participation exemption, and more than 20% of the foreign corporation's income is excluded thereunder). Q&A-8(b). Income may be excluded by virtue of an exemption, an exclusion, a deduction (including dividends received deduction or dividends paid deduction), or by a reduced rate of tax (i.e., less than 50% of the generally applicable rate). Notwithstanding the foregoing, income will not be treated as excluded for these purposes if it is effectively connected with a U.S. trade or business, a dividend from a U.S. corporation, or a dividend from a foreign corporation if substantially all of the latter corporation's income is subject to a

comprehensive foreign income tax. Q&A-8(c).

The second requirement is particularly significant in that most of the countries that have bilateral income tax treaties with the United States have a territorial system of taxation or a participation exemption. Thus, if a foreign corporation located in such a country has, for example, substantial dividend income from a subsidiary in another country that is not taxed by that other country on substantially all of its income under a comprehensive foreign income tax system, the foreign corporation will be treated as a nonqualified entity. For example, assume a foreign subsidiary is resident in Switzerland and receives substantial dividends from a second tier subsidiary in France. The treatment of the nonqualified deferred compensation arrangement sponsored or maintained by the Swiss subsidiary will depend on the taxation of the French subsidiary by France. Further, if the Swiss subsidiary receives substantial dividends from a second tier subsidiary in a non-treaty country, such as Hong Kong, then the treatment of the nonqualified deferred compensation arrangement sponsored or maintained by the Swiss subsidiary may depend on whether it can show that Hong Kong has a comprehensive foreign income tax and whether substantially all of the income of the Hong Kong entity is subject to local tax. Thus, in many instances, it may not be possible to apply section 457A with respect to foreign corporations, except on an after-the-fact basis by examining the items taken into income by the foreign corporation.

Note that there may be additional complications in applying this rule in the case of commonly used check-the-box structures, including so-called “super holding company” structures with lower tiered affiliates that are resident in third

countries and that are disregarded for U.S. tax purposes, but not for foreign tax purposes. Thus, continuing the example above, assume the French and Hong Kong lower tier subsidiaries are disregarded as separate from the Swiss holding company for U.S. tax purposes. In such a case, from a U.S. perspective, only the Swiss holding company is a corporation. One interpretation of section 457A and the Notice is that any nonqualified deferred compensation arrangement sponsored or maintained by the French or Hong Kong disregarded entities would be deemed to be sponsored or maintained by the Swiss holding company, and that the Swiss holding company therefore must be tested to determine whether it is a qualified entity. Further, to determine whether the Swiss holding company is a qualified entity, it may be necessary to consider the income of the disregarded entities in determining whether the holding company’s country of residence taxes substantially all of its income. This could lead to highly inappropriate results, including for example, the application of section 457A even when all of the income of each relevant entity (whether disregarded or regarded from a U.S. perspective) is taxed by each entity’s country of residence.

In the case of a foreign corporation subject to U.S. tax under Code section 882 (i.e., a corporation engaged in a U.S. trade or business), the Notice provides that section 457A will not apply to compensation if such compensation, had it been paid in cash on the date it ceased to be subject to a substantial risk of forfeiture, would have been deductible under the principles of section 882 by such foreign corporation. Q&A-12. This rule should generally exempt deferrals attributable to services performed for a U.S. branch of a foreign corporation.

Partnerships

As noted above, for a partnership to avoid nonqualified entity status, substantially all of the partnership's income (at least 80% of the partnership's gross income) must be allocated to persons (referred to in the Notice as "eligible persons") other than foreign persons who are not subject to a comprehensive foreign income tax and tax-exempt organizations under Title 26 of the U.S. Code. The Notice provides a detailed system of rules for determining the allocation of the partnership's gross income for these purposes, including rules that relate to a "U.S. relevant partnership" (a partnership filing a return under section 6031 or determining the distributive share of income of any partner under section 704) and rules relating to other partnerships. Under the Notice, partnership income may be treated as allocated to one (and only one) of the following: (i) the partnership if the partnership is the sponsor of the deferred compensation arrangement and is subject to a comprehensive foreign income tax with respect to such income; (ii) a partner of the partnership; or (iii) a direct or indirect owner of the partner. Q&A-11.

Covered Persons

The scope of section 457A encompasses not only employees but also individuals, partnerships, corporations, and personal service corporations, provided that persons who would be treated as a independent contractor that would be exempt from section 409A (e.g., because such person contracts with multiple customers or clients) will also be exempt from section 457A. Q&A-5.

What is Nonqualified Deferred Compensation

Generally, the definition of nonqualified deferred compensation tracks the definition in section 409A, including Treas. Reg. § 1.409A-1(a), and with respect to

arrangements between partners and partnerships, Notice 2005-1 (Q&A-7), Section II.E of the preamble to the proposed section 409A regulations (October 2005), and Section III.G of the preamble to the final section 409A regulations (April 2007). However, there are some important departures from the section 409A rules.

Under section 457A, there is a special rule for equity appreciation rights that treats as nonqualified deferred compensation a right to compensation based on the appreciation in value of a specified number of equity units, thereby including stock appreciation rights that would otherwise be exempt under section 409A; provided, however, that stock options and stock appreciation right that can only be settled in service recipient stock will be treated as exempt under section 457A if they would otherwise be exempt under section 409A. Q&A-2(b).

Furthermore, section 457A uses a different test of what constitutes a substantial risk of forfeiture in determining whether deferred compensation is exempt as a short-term deferral. Under this definition, a covered person's rights to deferred compensation will only be treated as subject to a substantial risk of forfeiture if they are conditioned on the performance of substantial services. Q&A-3(a). Accordingly, in those instances in which the covered person's rights are subject to a condition that is related to the purposes of the compensation (e.g., a financial performance condition), the covered person will not be treated as subject to a substantial risk of forfeiture by virtue of such condition, and may be subject to earlier taxation.

Finally, section 457A expands the scope of the short-term deferral exception by providing that this exception applies for section 457A purposes to compensation that is paid within 12 months after the end

of the service recipient's (not the service provider's) taxable year during which the covered person's rights to the deferral is no longer subject to a substantial risk of forfeiture. In addition, if the right to deferred compensation would qualify as a short-term deferral under section 409A (using the section 457A definition of substantial risk of forfeiture) because the deferral is paid within 2-1/2 months of service provider's or service recipient's taxable year in which vesting occurs, then the right will also constitute a short-term deferral under section 457A. The latter provision could be helpful if the service recipient's year ends early in the calendar year and vesting occurs at the end of the service recipient's year. Q&A-4(a).

Mechanics of Taxation

While the general rule under section 457A is that nonqualified deferred compensation is includible in income as soon as the deferred compensation is not subject to a substantial risk of forfeiture, inclusion will be delayed if the amount of the compensation is not determinable. Q&A-1.

The determination of the amount included in income under section 457A is made using the same rules as apply to calculation of the includible amount under section 409A, and once included, the service provider effectively gets a tax basis in such amount, so that when the deferred amount is paid, it will not be included again in the service provider's income. Q&A-16, 17. Note, however, that future earnings will be picked up as deferred compensation and potentially subject to tax under section 457A when the right to earnings is no longer subject to a substantial risk of forfeiture. Q&A-15.

Treatment of Amounts that are not Determinable

Notwithstanding the general rule of inclusion, an amount that is treated under

section 457A as not being "determinable" is not taxed at the time that the service provider's right to the amount vests. Instead, taxation is deferred until the amount becomes determinable. Q&A-20. At that time, however, additional amounts of tax are imposed equal to (i) 20% of the amount included, plus (ii) the premium interest tax (the underpayment rate under section 6621, plus 1%) attributable to the underpayment that would have occurred had the deferred compensation been includible in income when the amount was first deferred, or if later, became substantially vested. Q&A-21. For these purposes, a deferred amount will be treated as not determinable if the deferred amount would be subject to the rule for formula amounts under Prop. Reg. § 1.409A-4(b)(2)(iv) if it applied, provided that the amount payable in the future is dependent on factors that are not currently determinable, taking into account the assumptions in the proposed regulations. Q&A-19. These "determinable" rules will likely treat many performance plans that promise future payments based on the outcome of financial performance criteria as not being determinable.

Effective Dates

As noted, section 457A applies to deferred amounts that are attributable to services performed after December 31, 2008. Q&A-22. The Notice provides a number of rules for attributing compensation to periods of service for these purposes. Q&A-23. Under such rules, to the extent that a service provider's right to compensation is subject to a substantial risk of forfeiture (as defined for section 457A purposes) in the form of a requirement to perform substantial future services beyond 2008, the compensation is generally treated as attributed to the post-2008 period on a pro-rata basis.

The service attribution rules are generally keyed to the terms of the deferral arrangement in effect on December 31, 2008, but the Notice provides for special transition relief which allows the terms of the plan to be amended by June 30, 2009 to treat a substantial risk of forfeiture that would lapse after 2008 as having lapsed effective before 2009, thereby grandfathering the arrangement, if the amendment is made in writing and applies consistently to every service provider participating in the arrangement or a substantially similar arrangement. Q&A-23(a)(4). It is not entirely clear for purposes of this consistency rule whether or not the amendment must also extend to covered individuals who are not U.S. taxpayers, although there is no indication on the face of the language that they are excepted.

It should be noted that there is no permanent grandfather for pre-2009 deferrals. With respect to deferrals attributable to services performed before 2009, such amounts will eventually be includible in income, if not before, then by the later of (1) the last taxable year beginning before 2018, or the first taxable year the amounts are no longer subject to a substantial risk of forfeiture (as defined for section 457A purposes).

Coordination with Section 409A

The Notice makes it clear that income inclusion under section 457A is treated as a payment under the section 409A short-term deferral exception rules. In addition, the inclusion in income of future earnings under section 457A is treated for section 409A purposes, if certain conditions are met, as payment in accordance with a fixed schedule. Q&A-24. The Notice also addresses the application of section 409A to certain back-to-back arrangements. Q&A-27.

The Notice generally allows deferred compensation plans to be amended before December 31, 2011, with respect to deferrals attributable to services performed before 2009 to provide for their payment at a date that the amounts may have to be included in income under the special inclusion rule under section 457A referred to above without such action violating the section 409A anti-acceleration rule or being a material modification under the section 409A grandfather rules. Q&A-25. The Notice also provides relief under section 409A for those instances in which post-2008 deferrals become subject to taxation under section 457A at a time when they do not qualify as short-term deferrals under section 409A, e.g., the deferred compensation plan sponsor becomes a nonqualified entity after the time the deferrals have become substantially vested. In such instance, until further guidance is issued, it will not violate the section 409A anti-acceleration rules to make a payment of such amount in the year they become includible in income under section 457A. Q&A-26.

Conclusion

Section 457A represents a fundamental change in the taxation of deferral arrangements covering U.S. taxpayers employed by foreign corporations, including subsidiaries of U.S. corporations, and by certain partnerships. The Notice provides useful, although not comprehensive, guidance regarding the administration and implementation of section 457A. It is imperative that potentially affected taxpayers identify and evaluate all of their existing deferral arrangements, as well as the employees subject to those arrangements and the status of their employers as nonqualified entities, to determine the potential application and impact of section 457A. This will undoubtedly require close

collaboration between a company's benefits department and its tax department. Because of the punitive effect of being classified as deferral amounts which are not determinable, a company with exposure to section 457A may also want to consider whether it is possible to revise the deferral arrangements for covered individuals for the future to avoid such classification.

Finally, in light of the number of significant issues left unresolved, interested taxpayers should strongly consider submitting comments on the Notice. Subsequent guidance on a number of these issues, such as the provision of a "comprehensive foreign income tax" definition and guidance with respect to the application of the provision to "check-the-box" structures, will be critical in allowing

taxpayers to apply the new rules to their current deferral arrangements and structure future deferral arrangements.

For further information with respect to this Alert, please contact:

Anne G. Batter
 abatter@milchev.com
 202-626-1473

Rocco V. Femia
 rfemia@milchev.com
 202-626-5823

Marc J. Gerson
 mgerson@milchev.com
 202-626-1475

C. Frederick Oliphant
 foliphant@milchev.com
 202-626-5834

You may also contact any of the other members of our EB Group:

Thomas M. Cryan, Jr.
 tcryan@milchev.com
 202-626-1482

Jeannette Dayan
 jdayan@milchev.com
 202-626-6037

Elizabeth F. Drake
 edrake@milchev.com
 202-626-5838

Marianna G. Dyson
 mdyson@milchev.com
 202-626-5867

Garrett Fenton
 gfenton@milchev.com
 202-626-5562

Michael M. Lloyd
 mlloyd@milchev.com
 202-626-1589

Adrian L. Morchower
 amorchower@milchev.com
 202-626-5940

Anthony Provenzano
 aprovenzano@milchev.com
 202-626-1463

Gary G. Quintiere
 gquintiere@milchev.com
 202-626-1491

Susan Relland
 srelland@milchev.com
 202-626-1486

Donald T. Rocen
 drocen@milchev.com
 202-626-1497

Veronica A. Rouse
 vrouse@milchev.com
 202-626-1471

Lee H. Spence
 lspence@milchev.com
 202-626-5965