Management Alert

July 1, 2009: A Key Date for Section 457A Transition Relief

Companies with significant non-U.S. income, and partnerships that include foreign or tax-exempt partners, will need to assess whether new Internal Revenue Code Section 457A applies to their deferred compensation plans. If so, they will need to decide whether to take advantage of transition relief by amending plans to provide for immediate vesting before July 1, 2009.

Overview

Section 457A was added to the Internal Revenue Code (the "Code") as part of the Emergency Economic Stabilization Act of 2008. Section 457A generally provides that any compensation for services performed after December 31, 2008 which is deferred under a nonqualified deferred compensation arrangement sponsored by a "nonqualified entity" is includible in the service provider's gross income when it is no longer subject to a substantial risk of forfeiture (i.e., when vested). If the taxable amount is not determinable at the time it vests, the amount will be subject to tax when it first becomes determinable, and will be subject to a 20% penalty tax and interest.

In order for Section 457A to apply, the following elements must be present:

- There must be a "nonqualified entity"—generally either a foreign corporation located in certain countries or a partnership that includes foreign partners or tax-exempt entities,
- The nonqualified entity must "sponsor" a deferred compensation arrangement (broadly defined to include many severance and incentive arrangements), and
- A U.S. taxpayer (including a U.S. citizen working abroad) must participate in the deferred compensation arrangement.

What are "Nonqualified Entities"?

Although intended to apply primarily to U.S. investment managers of offshore hedge funds and to foreign corporations organized in tax havens, Section 457A is potentially broader. "Nonqualified entities" include:

- Foreign corporations that are not subject to a "comprehensive" foreign income tax, unless substantially all of the income of such corporation is subject to United States income tax, and
- Domestic and foreign partnerships that are wholly or partially owned by tax-exempt organizations or by foreign persons not subject to a comprehensive foreign income tax.

Determining whether a foreign entity is subject to a comprehensive foreign income tax may require a complex analysis. Clearly corporations formed in traditional tax haven jurisdictions, such as the Netherlands Antilles, or Bermuda, are

"nonqualified entities." However, under the IRS guidance, even a corporation located in a high-tax jurisdiction such as an EU country may be a nonqualified entity. The reason is that some countries, unlike the United States, only tax income of a resident company if it is earned within that country. Under IRS Notice 2009-8, if a foreign corporation is resident in such a country and more than 20% of its gross income is excluded or taxed at a lower rate because it is nonresident source income, or if the company's income is subject to more favorable tax rates for any other reason, it may be considered a "nonqualified entity."

A partnership is treated as a "nonqualified entity" if more than 20% of its income is allocated to partners that are either (1) foreign taxpayers not subject to a comprehensive foreign income tax, or (2) tax-exempt entities. Therefore, a partnership that includes any tax-exempt entity (such as a joint venture that includes a hospital or university) may be subject to Section 457A even if no foreign entities are involved.

When Does a Nonqualified Entity Sponsor a Deferred Compensation Plan?

IRS Notice 2009-8 provides that the "sponsor" of the deferred compensation plan is the entity that would otherwise be entitled to a deduction for the deferred compensation (if paid immediately) under U.S. federal income tax principles. To put this in perspective, in many multinational businesses, the senior managers of U.S. operations participate in plans of the corporate parent, which may be a non-U.S. company. If the compensation expense is charged back under U.S. tax principles to the U.S. company for which the manager works, the arrangement is not subject to Section 457A. For example, assume the president of a U.S. subsidiary of a foreign parent participates in the parent's incentive plans. If the expense is charged back by the foreign parent to the U.S. subsidiary, and is deductible by the U.S. subsidiary, the arrangement is not subject to Section 457A even if the parent is resident in one of the jurisdictions in which corporations may be considered nonqualified entities.

However, if an expatriate U.S. citizen is transferred on a full-time basis to a foreign affiliate that constitutes a nonqualified entity, so that the expatriate's compensation is not charged back to a U.S. entity, the arrangement may be subject to Section 457A.

The term "deferred compensation plan" is broadly defined for purposes of Section 457A, similarly to Section 409A, and may include severance plans, individual employment agreements that include severance or change of control provisions, and long-term incentive plans. Under Section 457A, an amount is an exempt short-term deferral if the compensation is paid within twelve months of the end of the employer's year in which the employee's right to compensation is nonforfeitable. A payment is considered forfeitable for purposes of Section 457A *only* if the employee must continue employment in order to receive the payment. Amounts that are conditioned upon the occurrence of an event, such as a change of control or achievement of performance targets, are not forfeitable if a former employee is still eligible to receive the payment. Cash-settled stock appreciation rights (SARs) are considered deferred compensation for purposes of Section 457A.

Who Needs to Address Section 457A?

Companies that have employees or other service providers in the following circumstances should closely examine the potential application of Section 457A to their deferred compensation arrangements:

1. Any U.S. taxpayer employed by a partnership that includes any tax-exempt or foreign partners, such as a research partnership between a tax-exempt hospital or university and a taxable entity.

2. Any U.S. taxpayer who is paid by an offshore employer if the compensation is not charged back to a business that pays U.S. income taxes. This would typically include persons paid by hedge funds and other financial institutions formed in traditional tax haven jurisdictions, but may include employers located in non-tax haven jurisdictions.
3. U.S. expatriates who are compensated by a foreign company while working abroad, but who continue to be U.S. citizens (even if their income is otherwise exempt from U.S. income tax), if the foreign corporation may not be subject to a comprehensive foreign income tax.

Effective Date and Transition Rules

Section 457A applies to amounts deferred that are attributable to services performed after December 31, 2008. Section 457A will not apply to deferred amounts attributable to services rendered prior to January 1, 2009, to the extent such amounts are vested (applying Section 457A's narrow definition of "substantial risk of forfeiture") as of December 31, 2008. However, such deferrals must still be included in taxable income no later than the last taxable year beginning before January 1, 2018, or, if later, the year in which any substantial risk of forfeiture lapses.

July 1, 2009 Transition Relief Deadline

Under IRS Notice 2009-8, transition relief provides a limited opportunity to amend plans before July 1, 2009, to provide that a substantial risk of forfeiture that would otherwise lapse on or after January 1, 2009 will be treated as having lapsed prior to January 1, 2009, thereby making such compensation eligible for the grandfathering rule described above. To qualify for this relief, the accelerated vesting must be applied consistently to all service providers participating in the same plan or any substantially similar arrangement. However, this transitional relief will not aid employers who do not wish to accelerate the vesting of their arrangements that are subject to Section 457A.

December 31, 2011 Transition Relief Deadline

For amounts attributable to services performed before January 1, 2009, companies have until December 31, 2011 to modify deferred compensation plans to change the distribution date to the Section 457A inclusion date without violating Section 409A's anti-acceleration and material modification rules.

For more information, please contact the Seyfarth attorney with whom you work, or any Employee Benefits attorney on our website (www.seyfarth.com/EmployeeBenefits).

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