. . . as published in . . .

PRACTICAL U.S./INTERNATIONAL TAX STRATEGIES

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A TWICE-MONTHLY REPORT ON US/INTERNATIONAL TAX PLANNING

Code Section 457A Requires Immediate Attention by Certain Sponsors of Nonqualified Deferred Compensation Arrangements

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As part of the Emergency Economic Stabilization Act of 2008, Congress added Section 457A to the Internal Revenue Code (Code), and in Notice 2009-8, the Internal Revenue Service (IRS) issued its first guidance under the provision. Under Code Section 457A, compensation that is deferred under an arrangement sponsored by certain non-U.S. or other "nonqualified" entities may be subject to immediate taxation when the compensation vests, even if not yet paid.[1]

Although the rules regarding the application of Code Section 457A are quite technical, sponsors that may be "nonqualified entities" should be aware of the following:

- Sponsors that wish to amend their arrangements to fit within a limited grandfathering provision under Code Section 457A have until July 1, 2009 to do so.
- Code Section 457A is aimed at curtailing U.S. income tax deferral on compensation paid by entities that are not taxed on substantially all of their income. Such entities are largely indifferent to when they receive a compensation deduction, so there is less of a trade-off between the benefit of the service provider's deferral of income tax and the cost of the entity's delayed compensation deduction.
- Non-U.S. corporations that sponsor nonqualified deferred compensation arrangements with employees or service providers that are subject to U.S. tax must consider the application of Code Section 457A if more than 20 percent of their gross income is not subject to a comprehensive income tax or if they have entered into a special taxing arrangement with a non-U.S. jurisdiction. In addition, U.S. and non-U.S. partnerships that allocate more than 20 percent of their gross income to non-U.S. and/or U.S. tax-exempt partners must consider whether their nonqualified deferred compensation arrangements are within the purview of Code Section 457A.
- A "sponsor" of a nonqualified deferred compensation arrangement may not be the entity that originally entered into the nonqualified deferred compensation arrangement. Under Code Section 457A, a sponsor is any entity that, if it had paid the deferred amount to the service provider would be entitled to a compensation deduction under U.S. income tax rules.[2] Importantly, for example, suppose a non-U.S. entity enters into a secondment arrangement with a U.S. entity. If the non-U.S. entity reimburses the U.S. entity for compensation deferred under an arrangement between the U.S. entity and the seconded employee, the non-U.S. entity may be treated as the sponsor of a nonqualified deferred compensation arrangement covering the employee.[3]
- Possibly affected sponsors will need to make an annual determination of whether they are "nonqualified."

The remainder of this article provides a more detailed discussion of the consequences of Code Section 457A, who should be concerned about it, and what should be done in response to it.

What are the Consequences of Code Section 457A?

With respect to amounts attributable to services performed after December 31, 2008, Code Section 457A provides that compensation deferred under a nonqualified deferred compensation arrangement of a "nonqualified entity" will be subject to immediate taxation when the compensation vests, even if it has not yet been paid.[4] If the value of the compensation is not determinable when it vests, then it will be included in the service provider's income in the year in which its value is determinable and will be subject to a premium interest charge, as well as an additional 20 percent tax.[5]

With respect to amounts attributable to services performed prior to January 1, 2009, Code Section 457A requires deferred amounts to be included in income in 2017 or upon vesting, if later (unless otherwise includable

in income at an earlier date).[6] In general, if compensation relates to a specific period of service and is not fully vested as of December 31, 2008, the portion of the deferral attributable to pre-2009 services and eligible for grandfathering treatment will be a pro rata portion based on the vesting period that occurs before 2009.[7]

For example, suppose that a nonqualified entity agrees on January 1, 2006 to pay $400,000 to an employee subject to U.S. tax on January 1, 2015, subject to the requirement that employment continue until December 31, 2010. In this case, a pro rata portion of the compensation is attributable to services performed during each of 2006, 2007, 2008, 2009 and 2010, so that 60 percent ($240,000) of the amount deferred is attributable to services performed before 2009. This portion is grandfathered under Code Section 457A and includable in income when paid in 2015. The remaining $160,000 is subject to Code Section 457A and includable in income on December 31, 2010, even though not paid until January 1, 2015.[8]

Under certain circumstances, an arrangement may be amended to qualify for this limited grandfathering relief. The amendment must provide that a substantial risk of forfeiture that would otherwise have lapsed on or after January 1, 2009, will be treated as lapsing prior to January 1, 2009. The amendment must be made in writing and effective prior to July 1, 2009 and must be applied consistently to every service provider participating in that arrangement or a substantially similar arrangement.

Under What Circumstances Does Code Section 457A Apply?

Code Section 457A applies only where a "nonqualified deferred compensation arrangement" is sponsored by a "nonqualified entity," as both terms are defined under Code Section 457A.

The Compensation Must be Nonqualified Deferred Compensation

The definition of nonqualified deferred compensation under Code Section 457A is similar to the definition under Code Section 409A.[9] Thus, certain broad-based foreign retirement plans, as well as certain stock options and stock-settled stock appreciation rights with an exercise price at least equal to fair market value are generally not subject to Code Section 457A. However, unlike Code Section 409A, cash-settled stock appreciation rights will constitute nonqualified deferred compensation and be subject to Code Section 457A, even if granted with an exercise price equal to or greater than fair market value on the date of grant.[10] Furthermore, Code Section 457A provides a short term deferral exception under which amounts will not constitute nonqualified deferred compensation if they are paid within 12 months after the end of the service recipient's taxable year in which the compensation vests.[11]

Under Code Section 457A, a substantial risk of forfeiture exists only if the right to compensation is conditioned upon the future performance of substantial services by the service provider, a definition of substantial risk of forfeiture that is more limited than otherwise found in the Code.[12] Thus, the attainment of a specific financial goal does not constitute a substantial risk of forfeiture under Code Section 457A. As a result, deferred compensation that would otherwise be considered unvested may be treated as vested for purposes of Code Section 457A.

Sponsors that wish to amend their arrangements to fit within a limited grandfathering provision under Code Section 457A have until July 1, 2009 to do so.

Finally, in contrast to Code Section 409A, a service provider may be subject to Code Section 457A whether it is a cash or accrual basis taxpayer.[13] (An independent contractor, however, is not a service provider subject to Code Section 457A if it has multiple unrelated clients.)[14]

The Sponsor of the Arrangement Must be a Nonqualified Entity

To be subject to Code Section 457A, the nonqualified deferred compensation arrangement must be sponsored by a "nonqualified entity." As a general matter, entities that have at least 80 percent of their gross income taxed under a comprehensive income tax and that have not entered into favorable taxing arrangements with a foreign taxing jurisdiction are not considered nonqualified.[15]

The determination of whether a corporation is a nonqualified entity is generally made as of the last day of each of the service provider's taxable years in which the nonqualified deferred compensation is vested.[16] For partnerships, the determination is made as of the last day of the service provider's taxable 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.[17] Thus, a sponsor can become a nonqualified entity during the service provider's taxable year and may be a nonqualified entity in one year but not in another.

Nonqualified Corporations

A non-U.S. corporation will generally be treated as a nonqualified entity unless at least 80 percent of the corporation's gross income is effectively connected with the conduct of a trade or business in the U.S. that is not

exempt from U.S. tax pursuant to a treaty, or is subject to a "comprehensive foreign income tax."[18] A comprehensive foreign income tax exists where: 1) the non-U.S. country (other than Bermuda and the Netherlands Antilles) has entered into an income tax treaty with the U.S., or the non-U.S. corporation demonstrates to the IRS that its country of residence has a comprehensive foreign income tax; 2) the non-U.S. corporation is not subject to a more favorable tax regime in its country of residence than the corporate income tax regime generally imposed; and 3) if the country of residence has adopted a territorial-based system of taxation that excludes nonresidence source income, the aggregate amount of "excluded" nonresidence source income does not exceed 20 percent of its gross income for that year.[19]

For this latter purpose, the non-U.S. corporation's nontaxable income is treated as "excluded" if it is not taxed on account of an exemption, exclusion, or deduction or is taxed at a rate that is less than 50 percent of the generally applicable rate.[20] Nonresidence source income is not treated as excluded, however, to the extent that it is received from a corporation that is itself subject to a comprehensive foreign income tax using this Code Section 457A definition.[21]

Possibly affected sponsors will need to make an annual determination of whether they are "nonqualified."

Nonqualified Partnerships

Partnerships may also be nonqualified entities under Code Section 457A. In general, a partnership will be a nonqualified entity if more than 20 percent of its gross income is allocated so that it is not subject to current U.S. federal income taxation or current taxation under a comprehensive income tax. In broad terms, both U.S. and non-U.S. partnerships will be nonqualified entities if more than 20 percent of their gross income is allocated to: 1) non-U.S. persons not subject to a comprehensive foreign income tax, unless such income is effectively connected to a U.S. trade or business and not otherwise exempt under a tax treaty; or 2) organizations that are exempt from U.S. federal income tax, unless such income is subject to U.S. income tax as unrelated business taxable income.[22] Special rules apply in the case of tiered partnerships.[23] Generally, income allocated to a non-U.S. corporation is treated as subject to a comprehensive foreign income tax if the corporation: 1) is itself a qualified entity; 2) is not "fiscally transparent;" and 3) takes the income into account on a current basis (other than under an anti-deferral regime).[24]

These definitions sweep in many non-U.S. corporations and partnerships that at first blush do not seem to be the type of tax-indifferent entities originally targeted by the legislation. They include non-U.S. corporations that enjoy favorable tax treatment with a foreign taxing jurisdiction. For example, an Israeli corporation that receives favorable tax treatment in exchange for giving an Israeli agency rights to its intellectual property would be a nonqualified entity. Likewise, suppose a Netherlands corporation receives more than 20 percent of its gross income in the form of dividends from a non-Netherlands corporation that is itself not subject to a comprehensive foreign income tax. Since the Netherlands has a so-called "participation exemption" that excludes from gross income dividends from certain non-Netherlands corporations, the Netherlands corporation may be a nonqualified entity. Finally, the rules for determining whether a partnership is a nonqualified entity are particularly troubling in that they require detailed knowledge not just of the tax treatment of the partnership, but also of the partners to the partnership.

What Should be Done about Code Section 457A?

Review Nonqualified Deferred Compensation Arrangements and the Tax Treatment of Sponsors

Code Section 457A has potentially broad applications. Non-U.S. entities should be examined to determine whether: 1) they are considered a "nonqualified" entity under Code Section 457A; and 2) they have any nonqualified deferred compensation arrangements with U.S. service providers. In particular, non-U.S. corporate sponsors at least 20 percent of whose gross income derives from jurisdictions that do not have a tax treaty with the U.S., or sponsors that have a special arrangement with a foreign taxing jurisdiction, should consider the detailed definition of a "nonqualified entity" under Code Section 457A. In addition, U.S. or foreign partnerships that allocate more than 20 percent of their gross income to foreign and/or U.S. tax-exempt partners should consider whether their nonqualified deferred compensation arrangements are within the purview of Code Section 457A. Because the determination of whether an entity is qualified is based on U.S. tax principles, the information necessary for this review may not be readily available. Sponsors, particularly those that wish to take advantage of the limited transition rules discussed above, should undertake this review soon.

Other Amendments

Nonqualified deferred compensation arrangements subject to Code Section 457A will generally also be subject to Code Section 409A.[25] Code Section 409A regulates the timing of deferral elections and the time and form of distributions of nonqualified deferred compensation. Because Code Section 409A restricts

the ability of sponsors to amend their arrangements to accelerate the payment of deferred compensation, it may not be possible for arrangements to be amended to provide for an accelerated payment on account of inclusion in income under Code Section 457A. The IRS, however, has provided some transition relief to allow for such modifications. First, if amounts are subject to both Code Section 409A and Code Section 457A and are attributable to services performed before January 1, 2009, the transition relief allows the sponsor to change the time of payment to conform the date of distribution to the date the amount may be required to be included in income under Code Section 457A.[26] Any such change must be made in writing and effective on or before December 31, 2011.[27] For deferred compensation attributable to post-2008 services, until further guidance is issued, the payment of a deferred amount in the year it becomes includable in income under Code Section 457A will not violate Code Section 409A's anti-acceleration rules.[28]

[1]Originally aimed at foreign hedge funds located in tax havens, the statute and IRS guidance expand the applicability from this initial concept to include entities that are not hedge funds and are not located in tax havens.
[2]Notice 2009-8, Q&A 14.
[3]Notice 2009-8, Request for Comments.
[4]Code Section 457A(a); Notice 2009-8, Preface and Q&A 1.
[5]Code Section 457A(c)(1); Notice 2009-8, Preface, Q&As 1, 21.
[6]Notice 2009-8, Q&A 22.
[7]Notice 2009-8, Q&A 23(a)(1),(3).
[8]Notice 2009-8, Q&A 23(b) Ex. 1.
[9]Notice 2009-8, Q&A 2(a).
[10]Notice 2009-8, Q&A 2(b).
[11]Notice 2009-8, Q&A 4(a).
[12]Notice 2009-8, Q&A 3(a).
[13]Notice 2009-8, Q&A 5.
[14]Notice 2009-8, Q&A 5.
[15]Notice 2009-8, Q&A 8(a),(b).
[16]Notice 2009-8, Q&A 13(a).
[17]Notice 2009-8, Q&A 13(b).
[18]Notice 2009-8, Q&As 6, 9.
[19]Notice 2009-8, Q&As 8(a),(b), and 10.
[20]Notice 2009-8, Q&A 8(c)(i).
[21]Notice 2009-8, Q&A 8(c)(iv)(C).
[22]Code Section 457A(b)(2); Notice 2009-8, Q&A 11(a),(e)(i) and (ii).
[23]Notice 2009-8, Q&A 11(d).
[24]Notice 2009-8, Q&A 11(f)(i)(A).
[25]Notice 2009-8, Q&A 24.
[26]Notice 2009-8, Q&A 25.
[27]Notice 2009-8, Q&A 25.
[28]Notice 2009-8, Q&A 26. ❑

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