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Employee Benefits Alert: Offshore Hedge Funds (Among Others) in the Cross-Hairs

IRS Issues Interim Guidance Implementing Code § 457A

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Section 801(a) of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008[1] added to the Internal Revenue Code (the "Code") new Section 457A. Code § 457A changes the tax rules that apply to deferred compensation arrangements maintained by certain foreign corporations and domestic and foreign partnerships. On January 9, 2009, the IRS issued Notice 2009-8, which provides interim rules implementing Code § 457A and invites comments on certain aspects of the new law. This client advisory explains the key features of Notice 2009-8.

Background

Code § 457A generally provides that compensation deferred under a *nonqualified deferred compensation plan* of a *nonqualified entity* is included in income when it is no longer *subject to a substantial risk of forfeiture*. This deceptively simple statement masks a daunting and complex reality. While Code § 457A principally targets and imposes tax penalties on deferred compensation arrangements maintained by offshore hedge funds domiciled in tax haven jurisdictions, it also reaches U.S. taxpayers that provide services to many foreign corporations and domestic and foreign partnerships. These rules could apply, for example, to operating partnerships and private equity funds, among others, that maintain deferred compensation arrangements such as phantom equity plans. Code § 457A is generally effective in 2009 for deferrals of income related to services performed after 2008, but existing deferrals will be subject to tax by 2017 (or, if later, when vested under the new rules).

Nonqualified Deferred Compensation Plan

Under Notice 2009-8, the term "nonqualified deferred compensation plan" has the same meaning as under Code § 409A(d) and Treas. Reg. § 1.409A-1(a) (*i.e.*, any plan, program, or arrangement that provides the deferral of compensation other than a qualified plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan). Statutory stock options are excluded from the definition of nonqualified deferred compensation plan, as are short-term deferral arrangements (though, as explained below, the definition of what constitutes a short-term deferral for purposes of Code § 457A differs in certain respects from the definition under Code § 409A). IRS Notice 2005-1, Q&A 7 permits taxpayers to treat the issuance of partnership interests (including profits interests) in connection with the performance of services as analogous to grants of equity-based compensation where the compensation is determined by reference to partnership equity. These rules are important for Code § 409A purposes, since stock options and stock appreciation rights that are issued on "service recipient stock" at "fair market value" (and that meet certain other requirements) are not subject to Code § 409A.

Special Rule for Stock Appreciation Rights

Stock appreciation rights (SARs) do not enjoy the same immunity from regulation under Code § 457A that they enjoy under Code § 409A (*i.e.*, on par with stock options). Rather, under Code § 457A, only SARs that by their terms must at all times be settled in stock are exempt.

Short-Term Deferrals

As is the case for Code § 409A purposes, short-term deferrals are exempt from regulation under Code § 457A. There are, however, two important differences:

- In determining whether a deferral may be treated as a short-term deferral, the Code § 457A definition of "substantial risk of forfeiture" applies (see below). Thus, vesting must be based on the continued performance of substantial services and not on meeting performance targets or the occurrence of an event related to the purpose of the compensation.
- For Code § 457A purposes, a short-term deferral refers to compensation that is paid not later than *12 months* (rather than 2½ months) after the end of the service recipient's taxable year during which the right to the payment of the compensation is first no longer subject to a substantial risk of forfeiture.

Notice 2009, Q&A 4 provided the following example of application of the short-term deferral rule in the Code § 457A context:

> If on January 1, 2009, an employee is provided a right to a future payment of $10,000 if the employee continues providing services to his or her employer through January 1, 2011, and the amount is paid out not later than 12 months after the end of the employer's taxable year that includes January 1, 2011, the arrangement is not subject to § 457A. However, if the amount is not paid to the employee before the end of that 12-month period, the arrangement is subject to § 457A and $10,000 is includible in the employee's gross income on January 1, 2011.

Special Rule for "Single Asset" Accounts

Code § 457A allows for a special limited exemption to be implemented by regulation where compensation is determined by reference to the amount of gain realized upon the disposition of an "investment asset." The term "investment asset" means for this purpose a single asset (and not an investment fund) with respect to which the entity does not exercise management rights, and for which gain and loss is separately allocated. Presumably, this is intended to reach so-called "side pocket" investments. A hedge fund "side pocket" is an account used to separate illiquid assets (*e.g.*, shares of a de-listed company) from other more liquid investments. Once an investment is deposited with a side pocket account, only the present participants (and not future investors) are entitled to a share of it. Investors who leave the hedge fund will still receive a share of the side pocket's value when realized. While a side pocket may consist of a single asset, there is nothing that requires this result.

Notice 2009-8 does not implement the "investment asset" exception. It does, however, invite comments relating to the scope of the definition of substantial risk of forfeiture that ought to be applied to this exception.

Nonqualified Entity

For purposes of Code § 457A, the term "nonqualified entity" means:

> (a) Any foreign corporation unless substantially all of its income is (i) effectively connected with the conduct of a trade or business in the United States, or (ii) subject to a comprehensive foreign income tax; and
>
> (b) Any partnership 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, and (ii) organizations which are exempt from tax (under Title 26 of the United States Code).

Nonqualified entities may include individuals, corporations, S corporations, partnerships, and personal service corporations, as well as noncorporate entities that would be personal service corporations if they were corporations. In contrast to Code § 409A (which does not apply to accrual basis taxpayers), a service provider may be subject to Code § 457A regardless of whether the service provider is a cash- or accrual-basis taxpayer. An independent contractor is not a service provider subject to Code § 457A if the arrangement with respect to the independent contractor would be excluded under Code § 409A. Thus, an arrangement with an independent contractor with multiple unrelated clients is not subject to Code § 457A, but an arrangement providing for management services is subject to Code § 457A.

As indicated above, the term “nonqualified entity” can include any foreign corporations and domestic or foreign partnerships unless certain requirements are satisfied relating to U.S. income and foreign income taxes and tax treaties.

Foreign Corporations

The term “foreign corporation” means a corporation that is not a domestic corporation using definitions supplied by Code § 7701. Generally, a foreign corporation is not a nonqualified entity if:

Substantially all of the income of a foreign corporation is treated as effectively connected with the conduct of a trade or business in the United States. Substantially all of the income of a foreign corporation is treated as effectively connected with the conduct of a trade or business in the United States if, for the taxable year of the foreign corporation ending with or within the service provider’s relevant taxable year, at least 80 percent of the gross income of the foreign corporation is “effectively connected” with the conduct of a trade or business in the United States; or

Substantially all its income is subject to a “comprehensive foreign income tax.” Substantially all of the corporation’s income is subject to a “comprehensive foreign income tax” if either (A) the foreign corporation is eligible for the benefits of a “comprehensive income tax treaty between its country of residence and the United States,” or (B) the foreign corporation is not taxed in a manner that is materially more favorable than the corporate income tax otherwise generally imposed by such country. But if the foreign corporation’s taxable income excludes, in whole or in part, nonresidence source income and the aggregate amount of such exceeds 20% of such foreign corporation’s gross income, then the exception is not satisfied. The term “comprehensive income tax treaty” generally means all income tax treaties of the United States other than the treaties with Bermuda and the Netherlands Antilles.

Partnerships

Partnerships are nonqualified entities if substantially all of a partnership’s income for a taxable year is allocated to persons other than:

foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax;

foreign persons with respect to whom such income is effectively connected to the conduct of a U.S trade or business; and

U.S. tax-exempt organizations.

The Notice refers to persons who are not “foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax” as “eligible individuals.” Thus, for example, a partnership is not a nonqualified entity with respect to a taxable year if substantially all of its income is allocated to eligible individuals. Substantially all of a partnership’s income is treated as allocated to eligible persons with respect to a taxable year only if at least 80% of the gross income of the partnership for such taxable year is allocated to eligible persons. The Notice prescribes detailed rules for determining whether substantially all of the income of a partnership is allocated to eligible persons, as well as special rules for nonresident alien individuals.

Notice 2009-8 establishes rules for determining whether and when a foreign corporation or domestic or foreign partnership can fit within the applicable exceptions and thereby escape classification as a nonqualified entity. This includes guidance on what constitutes eligibility for a comprehensive foreign income tax treaty, and what it means for a foreign corporation’s income to be effectively connected to a U.S trade or business.

Substantial Risk of Forfeiture

Under Code § 457A, the rights of a person to compensation are subject to a “substantial risk of forfeiture” *only* if such rights are conditioned upon the future performance of substantial services by such person. This rule represents an important break from the rules under Code § 409A (and Code § 83 for that matter). Rights to compensation (including stock rights) are not subject to a substantial risk of forfeiture merely because those rights are subject to the occurrence of a condition related to a purpose of the compensation, or are conditioned, directly or indirectly, upon the refraining from the performance of services. Also, and in a manner similar to Code § 409A, the addition or extension of any risk of forfeiture after the legally binding right to compensation arises is disregarded unless paid in an amount that is materially greater than the present value of the amount the recipient otherwise would have received absent such risk of forfeiture.

Income Inclusion—Timing and Amount

Compensation that is deferred under a nonqualified deferred compensation plan of a nonqualified entity is includible in gross income when it is no longer subject to a substantial risk of forfeiture unless the amount of the compensation is not determinable (in which case additional taxes will apply once the amount of compensation becomes determinable).

As is the case under Code § 409A, Code § 457A applies as well to earnings on deferred compensation. There is, however, an important difference. For Code § 409A purposes, once deferred compensation is included in income, even if not paid out, it is treated as settled. Thereafter, earnings are treated as additional income that is taxed when distributed, presumably at some other permissible distribution event such as separation from service. Under Code § 457A, however, income is taxed at least annually as it accrues. Notice 2009-8 refers to Notice 2008-115 for rules governing the timing and amount of income inclusion under Code § 457A. Thus, inclusion is determined on an annual basis, and gains and losses are netted for purpose of arriving at the taxable amount.

The Notice recognizes that there might be instances where an amount is included in income under Code § 457A before the amount is paid, and that such amount may be subsequently forfeited or otherwise permanently lost. Where this occurs, the service provider is entitled to a corresponding deduction.

The determination of whether an entity 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 no longer subject to a substantial risk of forfeiture and remains deferred. Thus, a plan sponsor can become a nonqualified entity during its taxable year, and it may be a nonqualified entity in one year but not in another. The IRS has requested comments regarding alternative approaches to determining whether and when nonqualified deferred compensation becomes subject to Code § 457A where the nonqualified deferred compensation is no longer subject to a substantial risk of forfeiture and is still deferred, and the entity becomes a nonqualified entity in a subsequent taxable year.

Where partnerships are concerned, nonqualified entity status is determined as of the last day of the service provider’s taxable year based on the allocations (or deemed allocations) of gross income by the partnership for the partnership’s taxable year ending with or within the service provider’s taxable year.

Amounts Not Determinable

Notice 2009-8 implements the special rule governing income inclusion where amounts are not determinable when vested. Unlike Code § 409A (which contains no special rules for such amounts) or Code § 3121(v) (which contains an accommodation for such amounts), Code § 457A imposes a tax penalty where deferred compensation vests at a time when the amount of the compensation is undeterminable. This could occur, for example, when the amount of the deferred compensation is subject to performance criteria, the satisfaction of which is yet to be calculated and certified.

When an amount is not determinable at the time that the compensation is otherwise includible in gross income under Code § 457A, the compensation is included in gross income when it becomes determinable. The amount included in income is increased by the sum of:

an amount equal to 20% of the amount of the compensation and

the “premium interest tax” on the compensation.

The premium interest tax is the amount of interest at the underpayment rate (under Code § 6621) plus one percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which it is not subject to a substantial risk of forfeiture. These rules are intended to be similar to those that apply to the excise and premium taxes under Code § 409A.

Effective Dates

Code § 457A generally applies to amounts deferred that are attributable to services performed after December 31, 2008. Amounts attributable to services performed before January 1, 2009, however, must be included in income before January 1, 2018 or, if later, the first taxable year in which there is no substantial risk of forfeiture—based on the Code § 457A definition of substantial risk of forfeiture (*i.e.,* ignoring performance conditions, among others). The Notice establishes a series of grandfather rules that mirror the approach adopted by the regulators under Code § 409A. Thus, plans can be bifurcated into grandfathered and non-grandfathered plans, provided that grandfathered amounts are not materially modified.

Plan sponsors have until the end of 2009 to retroactively amend their plans to come into compliance with Code § 457A. The Notice expressly allows for the shortening of vesting periods but only if applied consistently to all service providers participating in "substantially similar arrangements." This rule tracks the legislative history, which allows for the acceleration of the timing of distributions to match income inclusion under Code § 457A. A plan's sponsor might, for example, amend a plan under this rule to delete performance vesting conditions.

Request for Comments

The regulators have invited comments on the issues, such as:

- what constitutes a "comprehensive income tax treaty;"
- the treatment of reimbursement arrangements under which a domestic taxpayer service recipient might nevertheless be treated as a nonqualified entity;
- the potential scope of the exception to the definition of substantial risk of forfeiture relating to the "single investment asset" rule; and
- the proper treatment of trusts that are partners in a partnership and beneficiaries for purposes of determining to whom income of a partnership is allocated.

Conclusion

Code § 457A represents a fundamental change in the way offshore hedge funds and other corporations and partnerships must approach nonqualified deferred compensation. It may be possible, for example, to substitute carried interests or partnership allocations for fee-based arrangements on the theory that the latter look more like equity interests. The long-term viability of these approaches is questionable, however, since Congress has expressed an interest in regulating in these areas. For now, the focus should be on determining nonqualified entity status, identifying plans, adopting design changes where required, and, finally, adopting the necessary amendments and restatements.

Endnotes

[1]Pub. L. 110-343 (Oct. 3, 2008).

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