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December 29, 2008



## New Limitation on Deferral of Compensation Paid by Certain Foreign Corporations and Partnerships with Foreign and Tax-Exempt Investors

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Section 457A was added to the Internal Revenue Code of 1986 (the "Code") by the Emergency Economic Stabilization Act in October 2008 and will become generally effective with respect to deferred fees and compensation attributable to services performed after December 31, 2008.

### New Rule

Generally, Section 457A accelerates the timing of income inclusion of nonqualified deferred compensation payable by certain tax-indifferent parties, including offshore investment funds and U.S. investment funds that have foreign or tax-exempt investors. Section 457A is in addition to Section 409A of the Code, which has substantially changed taxation of nonqualified deferred compensation since January 1, 2005. Section 457A provides that any "nonqualified deferred compensation" (defined in accordance with Section 409A) of a "nonqualified entity" is taxable when it is no longer subject to a "substantial risk of forfeiture." Under Section 457A, a "substantial risk of forfeiture" exists only if the right to the compensation is conditioned upon the future performance of substantial services; performance goal requirements do not create a "substantial risk of forfeiture" for this purpose.

### Who Is Affected

Although Section 457A may apply to service providers who are subject to Section 409A, it also can apply to service

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providers who are not subject to Section 409A, such as accrual-method taxpayers and independent contractors.

Section 457A applies to payments from “nonqualified entities,” which are defined to include (i) many foreign corporations and (ii) certain partnerships. A foreign corporation is a “nonqualified entity” unless substantially all of its income is effectively connected with the conduct of a United States trade or business or is subject to a comprehensive foreign income tax. Both foreign and domestic partnerships (including limited liability companies taxed as partnerships) are “nonqualified entities,” unless substantially all of the partners are U.S. taxpayers (not tax-exempt entities) or foreign persons subject to comprehensive income taxation. Therefore, the new legislation will impact both offshore hedge funds and partnerships with any meaningful amount of investment from U.S. tax-exempt organizations, such as pension funds, or from foreign investors in tax-haven countries.

### **Nonqualified Deferred Compensation**

Under 457A, “nonqualified deferred compensation” is generally defined by reference to Section 409A, but also includes compensation that is based on the appreciation in value of equity units of the nonqualified entity. Therefore, distinct from Section 409A, stock appreciation rights (“SARs”) are nonqualified deferred compensation under Section 457A, regardless of the exercise price of the SAR.

### **Certain Exceptions**

#### *12-Month Deferrals*

Compensation that is paid within 12 months after the close of the taxable year in which the right to payment is no longer subject to a substantial risk of forfeiture is not treated as deferred under Section 457A.

#### *Deferred Compensation Based on Gain on Investment Asset*

Compensation determined solely by reference to the amount of gain recognized on the disposition of an investment asset is treated as subject to a substantial risk of forfeiture until the date of disposition of the asset. An “investment asset” is any single asset (other than an investment fund or similar entity) that is acquired directly by a nonqualified entity, where the entity does not participate in the active management of the asset. In addition, substantially all of the gain on the disposition of the investment asset must be allocated to

investors in the entity and the nonqualified entity may not net losses from other investments against the asset. This rule is intended to apply to compensation arrangements relating to passive investments by an investment fund in a single asset, such as carried interest in a portfolio company.

### **Special Rule for Compensation of Indeterminable Amount**

Under Section 457A, if the amount of any deferred compensation is not determinable at the time there is no longer any substantial risk of forfeiture, the amount is taken into account for income tax purposes when such amount becomes determinable. However, when it is taxed, such compensation will be subject to an additional penalty tax of 20% of the amount of the compensation, plus interest (at the underpayment rate under Section 6621 of the Code plus 1%) on the tax that would have been payable for the year the compensation was no longer subject to a substantial risk of forfeiture, if the compensation had then been determinable.

### **Services Rendered Before 2009**

Any deferred compensation that is attributable to services performed on or before December 31, 2008, to the extent it is not includable in gross income in a taxable year beginning before 2018, is includable in gross income in the later of 2017 or the taxable year in which it is no longer subject to a substantial risk of forfeiture.

### **Guidance Forthcoming**

The statute requires the Secretary of the Treasury to issue guidance no later than January 31, 2009, regarding deferred compensation attributable to services rendered before 2009, and specifically, to provide a limited period of time during which a nonqualified deferred compensation arrangement attributable to services performed on or before December 31, 2008, may be amended, without violating the requirements of Section 409A, to conform the date of distribution to the date the amounts are required to be included in income.

### **Action Items**

Service providers to “nonqualified entities” covered by Section 457A should determine whether any of their existing fee or compensation arrangements are subject to the rules of Section 457A and, if so, whether any changes to such arrangements are necessary to comply with the new rules.

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