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CLIENT UPDATE

Interim Guidance Issued on Offshore Deferred Compensation Law

New Section 457A of the Internal Revenue Code severely restricts post-2008 offshore fee deferrals by treating vested fees as current income, regardless of whether actually paid. Under §457A, after 2008, the tax treatment of unvested offshore fee deferrals remains unchanged such that they are not recognized as current income until the deferrals are no longer subject to vesting.

Among other things, guidance recently issued by the Internal Revenue Service specifies how to determine what is §457A deferred compensation, when §457A will apply, when compliance with §457A is required for pre-2009 deferrals, and how to conform existing offshore deferral programs without penalty.

What is §457A Deferred Compensation? Section 457A deferred compensation is defined by reference to §409A, which governs non-qualified deferred compensation in the United States generally. Under §409A, deferred compensation is any legally binding right to compensation that is payable in a future year, except where the compensation is subject to vesting and is paid within 2½ months after the year in which the compensation vests. However, the guidance makes clear that there are differences. For example, under §457A, a person's right to compensation is only subject to vesting (and, therefore, potentially not subject to §457A) if the right is conditioned upon the performance of future services. Under §409A, (but not under §457A) performance hurdles will also delay vesting.

In addition, §457A applies to all cash-settled stock appreciation rights that are exempt from §409A. Section 409A exempts stock appreciation rights that are paid in stock or cash. Section 457A also exempts payments made within 12 months after the year in which the compensation vests. This grace period is more forgiving than §409A's, which only permits a 2½ month delay. Also, for deferred amounts that are not determinable at vesting (e.g., because the amount is based on factors that remain variable), §457A permits an employee to delay income inclusion. However, this flexibility comes with a price: when determined, the amount is subject to a 20% penalty tax plus interest.

When will §457A apply? Section 457A applies where an employee receives deferred compensation from certain foreign corporations, or foreign or *domestic* partnerships. Covered foreign corporations include corporations where more than 20% of the corporation's income is

not effectively connected with the conduct of trade or business in the US or is not subject to a comprehensive foreign income tax scheme. In addition, covered partnerships (whether foreign or domestic) include partnerships where more than 20% of the partnership's income is allocated to tax-exempt investors or foreign taxpayers who are not subject to a comprehensive foreign income tax. The determination of whether an entity is covered by §457A is generally made as of the last day of the entity's taxable year in which the deferred compensation vests and remains deferred.

When is compliance with §457A required for pre-2009 deferrals? Section 457A applies to deferrals attributable to services after December 31, 2008. For deferrals attributable to services before January 1, 2009, §457A generally requires income inclusion no later than 2018 (even if not paid by then). Additionally, where deferred compensation can be attributable to services both before and after December 31, 2008, the guidance provides for an allocation formula where amounts are attributed to each period on a pro rata basis.

How to Conform Existing Offshore Deferral Arrangements? Transition relief allows taxpayers to modify their existing programs to comply with §457A without violating §409A. Modifications to the time and form of payment of deferred compensation will not be treated as an impermissible election under §409A if the change is made on or before December 31, 2011.

Similar relief is also provided for "back-to-back" arrangements (*e.g.*, where an "employee event" triggers a flow of payments from an offshore fund to its fund manager and ultimately to the fund manager's employee). However, this relief is not provided for "reverse back-to-back" arrangements (e.g., where a "fund manager event" triggers the same flow of payments). The guidance states that "reverse back-to-back" events are not permissible triggers under either §457A or §409A, and will result in income inclusion, and potentially interest charges and excise taxes.

If you have any questions relating to this guidance or deferred compensation please contact your primary attorney at Morrison Cohen LLP or any of the following:

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