SIMPSON THACHER

New IRC Section 457A Prohibits Deferral of Compensation Paid by Offshore Funds and Certain Partnerships

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EXECUTIVE SUMMARY

The Emergency Economic Stabilization Act added Section 457A to the Internal Revenue Code of 1986 (the "Code"). Section 457A (1) ends the deferral of vested compensation paid by offshore investment funds and certain other tax indifferent entities attributable to services performed for such entities after 2008 and (2) provides that vested deferred compensation payable by such funds and entities attributable to services performed before 2009 must be restructured to become taxable by no later than December 31, 2017. Although Section 457A was intended to target income deferral by managers of offshore hedge funds, nonqualified deferred compensation arrangements maintained by both foreign and domestic partnerships (including limited liability companies taxed as partnerships) are also covered unless substantially all of the partners of such entities are subject to comprehensive income taxation. By way of contrast, the earlier deferred compensation law (enacted as Section 409A of the Code) only regulates the manner in which compensation can be deferred and the time and form of payment of such deferred compensation.[1] Section 457A does not apply to profits interests in partnerships and therefore does not impact the treatment of typical carried interest allocations of private equity and other investment funds.

Section 457A provides that any compensation deferred under a "nonqualified deferred compensation plan" of a "nonqualified entity" becomes taxable when it is no longer subject to a "substantial risk of forfeiture" (as defined in Section 457A: i.e.; subject to a service-based vesting condition). However, if the compensation is paid not later than 12 months after the end of the taxable year of the nonqualified entity in which the compensation vested, then the penalty taxes imposed under Section 457A (a 20% additional income tax on the amount of compensation and interest penalties at the underpayment rate plus 1%) will not apply. If the amount of compensation is not determinable before the end of this grace period (for example, because a performance-based vesting condition has not been satisfied), taxation is delayed until the amount becomes determinable, but the Section 457A penalty taxes apply (a limited exception for compensation based solely on the disposition of a single investment asset is discussed below). Accordingly, Section 457A effectively negates any deferral of compensation paid by a nonqualified entity for services performed after December 31, 2008.

1 Note that, where applicable, Section 457A supplements and amends, but does not supersede, Section 409A.

Deferred compensation attributable to services performed prior to January 1, 2009 is entitled to 10-year transition relief. Such compensation must be included in income by the later of (1) the last taxable year of the nonqualified entity beginning before 2018 or (2) the taxable year of the nonqualified entity in which the compensation ceases to be subject to a substantial risk of forfeiture. Significantly, there is no transition relief for previously deferred amounts attributable to services performed after December 31, 2008 (e.g., deferred amounts which remain subject to ongoing service-based vesting conditions). Consequently, unless the transition relief rules are expanded by the U.S. Treasury Department to also cover arrangements that may vest in 2009 or beyond, nonqualified entities will need to make any necessary modifications to these arrangements by December 31, 2008.

FUNDAMENTAL PRINCIPLES UNDER SECTION 457A

Nonqualified Entity

A "nonqualified entity" includes:

- any foreign corporation UNLESS substantially all of its income is (1) effectively connected with the conduct of a trade or business in the U.S. or (2) subject to a comprehensive foreign income tax; or

- any partnership (whether domestic or foreign) UNLESS substantially all of its income is allocated to persons other than (1) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax and (2) tax-exempt organizations (including most pension plans).

A foreign person is subject to a comprehensive foreign income tax if (1) such person is eligible for the benefits of a comprehensive income tax treaty between a foreign country and the U.S. or (2) such person demonstrates to the satisfaction of the U.S. Treasury Secretary that the foreign country has a comprehensive income tax.[2]

An operating partnership will be a nonqualified entity under Section 457A unless substantially all of its income is allocated directly (or indirectly in the case of tiered partnerships) to persons who are subject to income taxation in the U.S. or under a comprehensive foreign income tax. Accordingly, for example, it is possible that an investment by a private equity fund in an operating partnership could cause the operating partnership to become a nonqualified entity depending upon the amount of the fund's income allocable to tax exempt organizations (such as state pensions plans) and/or nonqualifying foreign persons.

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2 Bermuda, the Cayman Islands, Dubai and Hong Kong are not currently considered to have a comprehensive foreign income tax.

Nonqualified Deferred Compensation Plan

Under Section 457A, a "nonqualified deferred compensation plan" is defined by reference to Section 409A(d), and includes any plan, program, or arrangement under which an employee or other "service provider" (as defined in Section 409A) obtains a legally binding right during a taxable year to compensation that is or may be payable in a later taxable year. This means that the same deferred compensation arrangements that are subject to Section 409A (for example, elective deferral plans, SERPs, and discount stock options) are also subject to Section 457A.

However, under Section 457A, a nonqualified deferred compensation plan also includes any arrangement under which compensation is based on the appreciation in value of a specified number of equity units of the nonqualified entity. This means that stock appreciation rights are subject to Section 457A. Section 457A may also require nonqualified entities to restructure many restricted stock unit, phantom equity and other "realization event" arrangements that are designed to pay out upon a change in control or other liquidity event involving a nonqualified entity. However, according to legislative history, Section 457A is not intended to apply to property subject to tax under Section 83, including options with an exercise price equal to grant date fair market value, restricted stock, partnership profits interests and similarly structured carried interest arrangements.

Substantial Risk of Forfeiture

As noted above, income is not taxable under Section 457A while it remains subject to a "substantial risk of forfeiture." However, compensation paid by a nonqualified entity is subject to a substantial risk of forfeiture only if the recipient's rights to such compensation are conditioned upon the future performance of substantial services (i.e., a service-based vesting condition). Unlike Section 409A, performance-based conditions do not create a substantial risk of forfeiture. Tying the amount of compensation to be paid to the achievement of an objective performance measure, which will often create a substantial risk of forfeiture under Section 409A, will not be effective in avoiding current taxation under Section 457A. However, compensation will not be subject to penalty taxes under Section 457A if it is paid within 12 months after the end of the nonqualified entity's taxable year during which the compensation ceases to be subject to a substantial risk of forfeiture. If the compensation cannot be paid during the above-mentioned time period because the amount to be paid is not yet determinable, the compensation will not be taxable until the amount becomes determinable, but the 20% penalty tax and interest penalties will apply.

Section 457A also includes a limited exception for compensation determined solely by reference to the gain recognized on the disposition of an "investment asset." An investment asset is any single asset acquired directly by a nonqualified entity where the entity (1) does not participate in the active management of the asset and (2) cannot net losses from other investments against the asset. Such compensation will only be taxable upon the ultimate disposition of the asset (without being subject to the penalties tax under Section 457A), even if the right to receive payment vests earlier. However, this exception is likely to be of limited use to most offshore fund managers due to the prohibition on netting gains/losses from other investments against the investment asset.

ADDITIONAL GUIDANCE FROM TREASURY

The U.S. Treasury is required to issue guidance no later than May 1, 2009 to provide a limited period of time during which pre-2009 nonqualified deferred compensation may be amended, without violating Section 409A, to conform the applicable payment date to the date the compensation is now required to be included in income under Section 457A. This guidance will also apply to so-called "back-to-back arrangements," where an investment manager has deferred payment of the fees it is entitled to receive from a fund it manages and employees or partners of the manager have also deferred the payment of their compensation from the manager that corresponds to the deferred fees.

ACTION ITEMS BEFORE 2009

- Foreign corporations and all partnerships (domestic and foreign) need to ascertain whether they are "nonqualified entities" and, if they are such entities, whether they maintain any nonqualified deferred compensation plans that will become subject to Section 457A. As discussed above, due to the significant investment in private equity, venture capital, real estate and hedge funds by tax-exempt organizations and non-U.S. investors, many partnerships that are directly or indirectly owned by such funds may be "nonqualified entities" under Section 457A.

- Affected entities will also need to determine how their nonqualified deferred compensation plans must be terminated, frozen or restructured in order to comply with both Section 409A and Section 457A and the date by which these changes must be made. Note that the deadline for making amendments to comply with Section 409A continues to be December 31, 2008.

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Alvin H. Brown
Partner
212 455-3033
abrown@stblaw.com

Andrea K. Wahlquist
Partner
212 455-2622
awahlquist@stblaw.com

Tristan M. Brown
Partner
650 251-5140 or 212 455-7970
tbrown@stblaw.com

Jeanne M. Annarumma
Counsel
(212) 455-7395
jannarumma@stblaw.com

SIMPSON THACHER

Gregory T. Grogan
Partner
212 455-2477
ggrogan@stblaw.com

Brian D. Robbins
Partner
212 455-3090
brobbins@stblaw.com

Rachel E. Berry
Counsel
212 455-7141
rberry@stblaw.com

Jamin R. Koslowe
Counsel
212 455-3514
jkoslowe@stblaw.com

The names and office locations of all of our partners, as well as additional memoranda, can be obtained from our website, www.simpsonthacher.com.

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