

# Client Alert

Employee Benefits Department

November 19, 2008

## **Emergency Economic Stabilization Act of 2008 (“Act”) Affects Certain Foreign Deferred Compensation Arrangements**

### **I. Deferrals in Certain Foreign Jurisdictions**

Under Internal Revenue Code (“Code”) Section 457 special rules apply to employees of tax-exempt organizations that require an employee to include an amount in income when the employee’s right to compensation is no longer subject to a substantial risk of forfeiture.

With the passage of the Act, a new Code section, Section 457A, has been added, the purpose of which is the current taxation of deferred income from certain tax indifferent parties, i.e., parties who are unconcerned about obtaining a tax deduction. It restricts the ability to defer taxation on compensation paid to a service provider by a nonqualified foreign entity pursuant to a nonqualified deferred compensation plan. Nonqualified foreign entities are:

- foreign corporations, unless substantially all of their income is subject to United States tax because it is effectively connected with a trade or business in the United States, or subject to a comprehensive foreign tax;
- any partnership, unless substantially all of its income is allocable to persons other than (i) foreign persons not subject to a comprehensive foreign income tax or (ii) tax-exempt organizations.

A foreign person is regarded as subject to a comprehensive foreign income tax only if the person is eligible for the benefits of a comprehensive income tax treaty with the United States or can demonstrate that the foreign country has a comprehensive income tax.

A “nonqualified deferred compensation plan” is generally defined in the same broad manner as under Code Section 409A, and includes not only traditional types of deferred compensation plans but also arrangements, with limited exception, deferring the receipt of income from one year to another. In addition, it includes plans that provide a right to compensation based upon the appreciation in value of a specified number of equity units of the service recipient (so stock options and restricted stock units would be included, but probably not carried interests which are taxed as property under Code Section 83), but excludes compensation that, when the right to payment vests, pays out within 12 months after the end of that taxable year, or, in the case of a foreign corporation subject to tax under Code Section 882, would have been deductible against effectively connected income.

“Substantial risk of forfeiture” is defined more narrowly than under Code Section 409A, which itself adopted a narrower definition of substantial risk of forfeiture than under Code Section 83. Specifically, a service provider’s right to compensation is subject to a substantial risk of forfeiture only if such right is conditioned upon the performance of substantial services in the future. However, to the extent provided by regulations, if the amount of deferred compensation is tied solely to an investment asset, then the deferred amount is treated as subject to a substantial risk of forfeiture until the asset is sold. For this purpose, an investment asset is a single asset (other than an investment fund interest) directly held by an

investment fund that is not actually managed by the fund or a related person and substantially all of the gain is allocated to investors.

If a taxpayer receives deferred compensation under a nonqualified deferred compensation plan from a nonqualified foreign entity, and such amount cannot be reasonably determined at the time awarded, Code Section 457A imposes an interest charge on the amount ultimately determined through the date such amount is determined, plus an additional tax equal to 20 percent of the amount of the compensation. This provision will be of particular concern with respect to nonaccount balance plans, e.g., a defined benefit plan SERP, where the benefit is a function of final average compensation.

Code Section 457A is generally effective with respect to deferred amounts attributable to service performed after 2008. With respect to deferred compensation that is attributable to pre-2009 service, such deferrals must be included in the service recipient's income by the later of 2017 or the year that they cease to be subject to a substantial risk of forfeiture. Because Code Section 409A would generally preclude the acceleration of deferred compensation, Treasury is directed to issue, within 120 days of enactment of the Act, guidance permitting, for a limited period of time, the acceleration of pre-2009 deferrals to pre-2018 periods.

While the primary focus of the Act was on compensation received by hedge fund managers, the Act is not by its terms so limited, and could apply in other contexts.

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