New York State Bar Association
Tax Section

Employee Benefits Committee

Report on Rules Governing Nonqualified Deferred Compensation Under Section 457A

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Report No. 1193

New York State Bar Association
Tax Section

Report on Rules Governing Nonqualified Deferred Compensation Under Section 457A[*]

This Report[1] relates to Section 457A,[2] which requires the inclusion in income of any compensation deferred under a nonqualified deferred compensation plan of a nonqualified entity when the compensation is no longer subject to a substantial risk of forfeiture or, if the amount of compensation is not determinable at that time, when the amount becomes determinable.[3]

I. Introduction

A. Background

The comprehensive codification of the taxation of nonqualified deferred compensation began with the enactment of Section 409A, added to the Code by the American Jobs Creation Act of 2004. In general, Section 409A provides that amounts deferred under a nonqualified deferred compensation plan are currently includible in an employee's gross income to the extent such compensation is not subject to a substantial risk of forfeiture (for purposes of Section 409A) and was not previously included in the employee's gross income, unless certain requirements are met. Further, noncomplying deferrals are subject to an additional 20 percent tax and additional interest on any related underpayment of taxes. Now, Section 457A, which was added to the Code by Section 801 of the Emergency Economic Stabilization Act of 2008[4] ("EESA"), has further codified the taxation of nonqualified deferred compensation.

There is evidence that early legislative proposals that ultimately led to the enactment of Section 457A focused upon addressing deferred compensation to managers of offshore hedge

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[*] Opinions expressed herein are those of the Tax Section of the New York State Bar Association, and do not represent those of the New York State Bar Association unless and until they have been adopted by the Association's House of Delegates or its Executive Committee.

[1] The principal drafters of this Report were Jason R. Factor and Andrew L. Oringer. Significant contributions were made by Andrew H. Braiterman, Jonathan P. Brose, Jean Cogill, Edmond T. FitzGerald, Robert H. Frastai, Mark A. Holdsworth, Meredith J. Jensen, David E. Kahen, Joshua A. Lichtenstein, Erika W. Nijenhuis, Michael Nissan, Amanda H. Nussbaum, Regina Olshan, Edward J. Rayner, Susan E. Stoffer, Willard B. Taylor and Mirna Zwitter-Tehovnik. Helpful comments were received from Kimberly S. Blanchard, Peter H. Blessing, Robert Cassanos, Michael S. Farber, Elizabeth T. Kessenides, David S. Miller, Andrew W. Needham, Deborah L. Paul, David Sachs, Michael L. Schler, David H. Schnabel and Richard R. Upton.

[2] Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[3] We have previously discussed some of the context of the legislation in our "Report on Proposed Carried Interest and Fee Deferral Legislation" (Report No. 1166, Sept. 24, 2008).

[4] P.L. 110-343, Div. C.

funds.[5] As the legislation evolved, Congress increasingly focused on tax principles relating to whether the service recipient has a tax-motivated reason to resist a service provider's possible desire to defer compensation. In particular, if the service recipient is tax-indifferent, especially in respect of whether there is a tax deduction that would be deferred by virtue of the deferral of compensation, there appears to have been a concern that inappropriate deferrals might be more likely to arise.[6] After the statute was enacted, it became clear that its reach extended beyond the initially intended targets, reaching both to certain types of offshore entities other than hedge funds, and even to certain types of domestic entities.

Thus, the scope of Section 457A is potentially extremely broad. With certain limited exceptions, Section 457A applies to amounts under a deferred compensation plan if (i) the plan is a "nonqualified deferred compensation plan" and (ii) it is maintained by a "nonqualified entity." Section 457A makes such amounts currently includible in income when such amounts are no longer subject to a "substantial risk of forfeiture." If, however, an amount is not "determinable" at the time it would otherwise be includible in income under Section 457A (i.e., when there is no

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[5] In an October 18, 2007 summary released by Representative Emanuel and Senator Kerry, this focus was made explicit, stating:

> There is a fundamental issue of equity between middle-class Americans who can elect to defer up to $15,500 of income into qualified plans and an additional $4,000 into their IRA's and higher-income U.S. taxpayers who can defer unlimited amounts offshore. Most recently, the issue has been highlighted by news accounts of U.S. hedge fund managers being able to defer billions of dollars of compensation offshore.

[6] Congressman Rangel's report included with H.R. Rep. No. 431, 110th Cong., 1st Sess. (2007), an earlier bill containing provisions ultimately codified in Section 457A, states as follows:

> Under present law, there is a tension in the case of a nonqualified deferred compensation agreement between a service provider and a taxable service recipient. This arises because the timing rule under the Code defers the service recipient's deduction for nonqualified deferred compensation until the taxable year in which such compensation is includible in the service provider's gross income. This tension may limit the amount of compensation that a service recipient is willing to permit a service provider to defer under a nonqualified deferred compensation arrangement. Even where this tension does not limit the amount of compensation that a service recipient is willing to permit a service provider to defer under a nonqualified deferred compensation arrangement, this tension ensures that the cost of allowing this deferral is borne by the service recipient.
>
> Under present law, the ability to defer nonqualified deferred compensation is limited in certain cases in which this tension is not present. Where this tension is not present, the cost of allowing service providers to defer under a nonqualified deferred compensation arrangement is not borne by the service recipient. Instead, this cost is borne by the Treasury. In order to limit the cost to the Treasury, Congress passed special rules limiting deferral in certain situations. Specifically, Section 457 provides special rules that limit deferred compensation arrangements sponsored by State and local governments and other tax-exempt entities.
>
> The Committee has become aware of other situations in which the present law tension does not exist. Specifically, foreign corporations that are not subject to a comprehensive income tax and partnerships that are comprised of foreign persons and U.S. tax-exempt entities are indifferent to the timing of deductions for nonqualified deferred compensation. The Committee believes that in such cases additional rules should apply that limit the ability to defer service provider compensation.

substantial risk of forfeiture), the amount is includible in income when it is determinable subject to an additional 20 percent tax and imputed interest (at the underpayment rate plus 1 percent) as if the deferred compensation had been includible in income as of the time the income was not subject to substantial risk of forfeiture.

Compensation is subject to a substantial risk of forfeiture only if a person's right to the compensation is conditioned upon the future performance of substantial services by any individual (which, as discussed below, is a narrower definition than that applicable under Section 409A) or is conditioned upon the disposition of an "investment asset." Section 457A will apply to deferred compensation attributable to services performed starting January 1, 2009. Deferred compensation attributable to services performed prior to that are eligible for a transition rule and can be deferred until the last taxable year of the service provider beginning before 2018 or, if later, the taxable year in which the compensation is no longer subject to a Section 457A substantial risk of forfeiture.[7] Accordingly, Section 457A largely eliminates the ability to defer compensation payable from certain entities – very generally, foreign corporations that are incorporated in tax haven jurisdictions or that otherwise do not pay foreign tax on substantially all of their income and that are not subject to U.S. net income tax, and pass-through entities unless the partners of such entities are subject to U.S. or foreign tax. Section 457A is relevant to any nonqualified deferred compensation of any service provider that is a U.S. person and any foreign person that is subject to U.S. tax in respect of such compensation income, where the compensation is earned from such "nonqualified entities."

The legislative history includes several reports prepared by the Joint Committee on Taxation. The most relevant of these are a May 2008 report ("H.R. 6049 JCT Explanation")[8] relating to H.R. 6049, the Energy and Tax Extenders Act of 2008,[9] a September 2008 report ("H.R. 7060 JCT Explanation")[10] relating to H.R. 7060, the Renewable Energy and Job Creation Tax Act of 2008,[11] and the March 2009 "General Explanation of Tax Legislation Enacted in the 110th Congress" ("Blue Book").[12] Section 457A as passed in the final legislation is more similar to the version contained in H.R. 6049 than to that contained in H.R. 7060. However, the Blue Book suggests this may have been unintentional.[13]

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7 EESA § 801(d).

8 JCX-39-08.

9 The Joint Committee did not issue a technical explanation of Section 457A when it was enacted by EESA in October 2008. The version of Section 457A as enacted was taken (subject to minor amendments) from H.R. 6049 (Energy and Tax Extenders Act of 2008), which had been introduced and passed in the House of Representatives on May 21, 2008.

10 JCX-75-08.

11 H.R. 7060 (Renewable Energy and Job Creation Act) (introduced and passed in the House of Representatives on September 26, 2008) contained another version of Section 457A. This version was similar but not identical to the one contained in H.R. 6049, and the actually enacted section reverted back to the version contained in H.R. 6049.

12 JCS-1-09.

13 *See* Blue Book at 530, n. 880.

Against this backdrop, the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") quickly and helpfully issued Notice 2009-8[14] (the "Notice"), which provides interim guidance on the application of Section 457A, and we appreciate and commend their efforts. However, numerous interpretive, administrative and practical questions remain regarding the reach and application of Section 457A, especially in light of what is now understood to be its expansive scope. We understand that Treasury and the Service are anxious to provide guidance that will facilitate the interpretation and administration of Section 457A, and this Report is submitted in that spirit, identifying certain areas where we believe Treasury and the Service should issue guidance, and offering related recommendations. We have also made certain recommendations for legislative changes.

The remainder of this Part I is divided into two sections. The first section is an "Executive Summary" of our recommendations for guidance. It also outlines our recommendations to Congress for corrections to the statute to make it more administrable and, we believe, consistent with the underlying statutory purposes. The second section is an overview of the main differences between Sections 409A and 457A. The remaining Parts of the report then identify specific areas where we believe Treasury and the Service should issue guidance, and offer recommendations relating to such guidance.

B. <u>Executive Summary</u>

Our principal recommendations are set forth below. They include recommendations for statutory changes as well as suggestions for how regulations should be drafted.

Before turning to our specific recommendations, it may be helpful to set forth some of the principles that have guided our thinking:

<u>Appropriate scope</u>. Section 457A applies to many more enterprises than just hedge funds (notwithstanding general impressions as to the impetus behind the passage of Section 457A) and, in fact, many of the organizations that will have the most difficulty in applying Section 457A are multinationals with subsidiaries in multiple jurisdictions, employees that move among the various jurisdictions during the course of their careers, and worldwide compensation plans that apply to U.S. employees and foreign employees alike. There are a few implications that flow from this.

First, given this context, we think there is significant value to having rules that are clear and are not overbroad, since the result otherwise may be to affect worldwide compensation plans that may have few if any U.S. participants. (Since the employer may not know the taxpayer status of each employee, some such plans may have no U.S. taxpayer participants at all in some years). Practical interpretive and compliance difficulties are exacerbated by the multidisciplinary nature of Section 457A, and its implications for benefits, international and partnership issues. If determining whether a particular plan sponsor is a "nonqualified entity" involves complicated determinations of law, can be dramatically affected by changes in facts year to year, and must be evaluated annually, overbroad applicability is likely.

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[14] 2009-4 I.R.B. 347.

Second, it is worth noting that there has recently been a significant push by government officials (both U.S. and non-U.S.), by institutions as a matter of internal risk management, and by other participants in the commercial marketplace, to require that a larger portion of compensation of employees of financial institutions and other business enterprises be deferred until the benefits of the transactions on which the compensation is based are more certain to be ultimately realized. The purpose is to align the incentives of the service provider with that of the service recipient, and to reduce systematic risks to the financial markets created by compensation based on short-term results. We believe that Section 457A should be administered (and where relevant, amended) so that it does not impose penalties on deferred compensation in situations where regulatory and other non-tax considerations impel deferral.

Third, given the fact that Section 457A will be relevant to a potentially broad spectrum of foreign service recipients, we believe that administrability will be eased and results will be more consistent to the extent that certain relevant determinations (e.g., the identity of the "plan sponsor" and the calculation of "substantially all of the income" of the plan sponsor) are done looking to foreign law rather than U.S. tax principles including, in particular, the "check the box" rules.

Administration and compliance. A second broad theme relates to administration and compliance. Section 457A is unusual in that while the tax effects of being subject to Section 457A are visited solely on the U.S. service provider, one of the primary issues in applying Section 457A is the status of the service recipient (i.e., whether it is or is not a nonqualified entity). This status will often not be obvious, may change year to year, and may depend on specific facts available solely to the service recipient. Moreover, the service recipient (or the partners of the service recipient, if it is a pass-through entity) will generally be indifferent to whether or not Section 457A applies, in the sense that the only effect of Section 457A would be potentially to accelerate a deduction. (Obviously many service recipients do take into account the tax implications that may apply to their employees or other service providers, where these implications are known and can be mitigated). Given this context, we believe that the determination of whether an entity is a nonqualified entity should be subject to rules that place the burden of compliance on those U.S. person(s) best suited to have access to or control over the necessary information, and that the rules should not require service providers without reasonable access to the relevant facts to establish that they were not providing services to a nonqualified entity.

Underlying the question of how the technical rules should work is the basic question of what should be the *default* position – in the absence of the relevant facts, should the service recipient generally be treated as a nonqualified entity, or not? The relevant facts may not be known to the service provider (and, on audit, by the Service) because the service recipient has not provided them, or the relevant facts may not even be known, or knowable, by the service recipient itself (e.g., because it has partners that have not provided relevant information and there is no method to compel them to provide it). This is not a practical issue with hedge funds and similar investment funds as currently structured, since all or close to all of them are organized in tax haven jurisdictions and clearly would be nonqualified entities under almost any definition. We do not think it would in practice be problematic for the effective default rule for hedge funds or similar investment funds to have nonqualified entity status. By contrast, however, where the

service recipient is an operating entity, we do not think it is the correct result for the rules to in effect make nonqualified entity status the default presumption in the absence of contrary facts.

Statutory purpose of nonqualified entity definition. A third broad theme is that Section 457A should be applied to the extent possible (or amended, if not) to be consistent with the underlying statutory purpose of applying to entities that are indifferent as to whether, or when, their compensation deduction is available. In this respect, we believe that the current statute should not focus on whether the plan sponsor has substantially all of its income subject to tax (U.S. or foreign). It would be more appropriate to focus on whether there is sufficient gross income subject to tax that could be offset by a deduction for compensation expense. Once there is sufficient gross income that can be offset by compensation deductions, the existence or non-existence of other tax-free income ought to be irrelevant. This underlying statutory identification of tax-indifferent entities creates tremendous complexity (measuring income, requiring treaty residence, etc.), and makes it difficult to interpret the inevitable ambiguities in the rules in a manner that supports a particular policy result. Although we recognize that Treasury and the Service do not have authority to rewrite the statute in this respect, we do believe that where possible the statutory language should be interpreted in a manner that is conducive to identifying tax indifference and not in a manner that draws arbitrary differences among service recipients. This would suggest, for example, that the U.S. classification of subsidiaries of a foreign plan sponsor generally should not be relevant, that limitations on benefits clauses in treaties generally should not be relevant, that partnerships should look to allocations of gross compensation expense and not income, and various other proposals described in the detailed discussion.

In order to eliminate the need for continual retesting, a number of key determinations should be made when the service provider becomes legally entitled to the right to compensation rather than, for example, when the compensation is no longer subject to a substantial risk of forfeiture. We believe that this is consistent with Section 457A's purpose, as the point at which the status of a service recipient as tax-indifferent (or not) is significant is when it negotiates the compensation arrangement with the service recipient, which will take place prior to the point at which the service provider becomes legally entitled to the compensation right.

Harmonization with Section 409A. Finally, Sections 409A and 457A should be harmonized, except where differences in statutory language or statutory purpose call for different rules. At a minimum, if a plan is amended solely to avoid the application of Section 457A, such amendment should not trigger the application of Section 409A.

1. Recommendations for Statutory Change

Relevance of foreign law.[15] We understand that some Treasury and IRS officials may believe that the statutory language of Section 457A does not permit the determination of whether an entity is a nonqualified entity by reference to foreign (rather than U.S.) tax rules. As indicated above, we believe that the conceptual basis for Section 457A is that a tax-indifferent service recipient is an entity that will not care when a deduction for compensation is available. Accordingly, if necessary, Section 457A should be amended to place primary significance on

[15] *See* discussion under Part III.A.1

whether an entity or investor therein benefits from compensation deductions, determined under applicable foreign law.

Allocations of compensation expense.[16] Similarly, if Treasury and the Service believe that the statutory language of Section 457A does not permit partnerships to look to allocations of gross compensation expense rather than gross income, the statute should be amended to allow this.

Effectively connected income ("ECI").[17] Congress should extend the rule in Section 457A(d)(4) so that it applies to partnerships as well as foreign corporations.

Death and disability.[18] To the extent that Treasury and the Service do not believe they have authority to provide regulations to this effect, Congress should consider providing that nonqualified deferred compensation is neither subject to the additional taxes imposed on nondeterminable amounts nor includible in income in the taxable year the service provider dies or becomes disabled if in-service death or disability are the only circumstances under which the rights to such compensation are not conditioned on the future provision of substantial services.

Investment asset exception.[19] The investment asset exception as drafted will be of no relevance to most or possibly all hedge fund side pocket arrangements. Accordingly, the exception should be revised to permit compensation to be determined by reference to net gain from multiple illiquid investment assets and to clarify that dividends and other types of non-capital gain income may be taken into account. We also recommend the allocation requirement be removed.

Section 457 election.[20] A partnership that is subject to Section 457A solely because it has one or more partners subject to Section 457, such as tax-exempt hospitals or local governments, should be permitted to elect to apply Section 457 rather than Section 457A.

2. Recommendations for Regulations

a. Recommendations Relating to Nonqualified Deferred Compensation

Compliance. As between the service recipient and the service provider, the service recipient generally is the only party capable of determining whether it is a nonqualified entity. However, many service recipients will not be U.S. taxpayers, and in any event may be better off if classified as nonqualified entities, because of the accelerated deductions they could receive. Accordingly, we believe that the most effective way to ensure compliance with Section 457A is to impose the burden of that compliance on service providers who are in a position to have access to or control of the necessary information and who are more likely to have influence over

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[16] *See* discussion under Part III.B.1

[17] *See* discussion under Part II.D.2.

[18] *See* discussion under Part II.C.4.

[19] *See* discussion under Part V.B.1.

[20] *See* discussion under Part IV.D.

the structuring of the service recipient's deferred compensation plan. Conversely, there will be many service providers that have no ability to negotiate with or demand information from the service recipient, and we believe that the statutory purpose is not served by potentially imposing on such service providers the punitive consequences of (and any penalties for noncompliance with) Section 457A. Consequently, we recommend a three-tier classification of service providers, with different rules applicable to each:

- Service providers receiving compensation below a threshold to be specified by Treasury and the Service should be exempt from Section 457A altogether.
- Other service providers generally would be entitled to rely upon information provided by the service recipient as to whether it is or is not a nonqualified entity. They would not be subject to penalties if they made a good faith effort to determine whether the service recipient is a nonqualified entity, or if they were told that the service recipient is not a nonqualified entity and that turned out to be wrong, unless they knew that the information was incorrect.
- Service providers with managerial authority, greater access to information, or power to influence the actions of the plan sponsor would be fully subject to Section 457A. These service providers thus will have both the means and the incentive to ensure that the service recipient's deferred compensation plan complies with Section 457A.

We recommend in general that nonqualified entity determinations should be made on the basis of tax returns as filed and should not be retroactively redetermined if and when a service recipient is audited and income is adjusted or reallocated among affiliated entities.[21]

Stock appreciation rights. We recommend that the rules for stock-settled stock appreciation rights ("SARs") be expanded by including SARs on equity of non-corporate entities such as partnerships and limited liability companies ("LLCs"), and cash-settled SARs. We also recommend that transfers of property subject to Section 83 be expressly excluded from coverage under Section 457A, as is the case for Section 409A.[22]

"Broad-based plan" exception. We recommend that plans of operating companies under which a substantial proportion of the participants and of the deferred compensation is payable to persons who are not U.S. taxpayers be excluded from the definition of "nonqualified deferred compensation" for purposes of Section 457A.[23]

"Substantial" services. The concept of "substantial" services should be defined with reasonable flexibility rather than by reference to a minimum period of service. For example, if substantial services are required to effect a sale of property, it should not matter whether the services can be or are expected to be provided over a short period of time. Guidance should

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[21] *See* in general discussion under Part II.A.

[22] *See* discussion under Parts II.B.1, II.B.3 and II.B.4.

[23] *See* discussion under Part II.B.6.

clarify whether a requirement to provide substantial services can be derived from the legal terms of a services arrangement, or whether there must be express words to that effect.[24]

Death and disability. To the extent Treasury and the Service feel they have authority to do so, they should provide that nonqualified deferred compensation is neither subject to the additional taxes imposed on nondeterminable amounts nor includible in income in the taxable year the service provider dies or becomes disabled if in-service death or disability are the only circumstances under which the rights to such compensation are not conditioned on the future provision of substantial services.[25]

Short-term deferral. The Section 409A concept of "actual or constructive receipt" and the Section 409A rule for unforeseeable events should apply for purposes of the Section 457A short-term deferral rule.[26]

ECI. The rules treating compensation as not subject to Section 457A if paid by a foreign corporation substantially all of whose income is ECI should provide that the exception applies if the corporation has a net loss or the compensation expense is capitalized into the basis of an asset used in the U.S. trade or business (including goodwill), and should provide guidance on how the corporation can establish that the exception applies. In addition, the statutory exception for compensation deductible against a foreign corporation's ECI should be extended to partnerships.[27]

Independent contractors. The determination as to when a service provider qualifies as an independent contractor should be made at the same time as for purposes of Section 409A, i.e., when the service provider becomes legally entitled to the right to compensation. Guidance should clarify for purposes of Sections 409A and 457A that providers of management consulting or other advisory services are eligible for the independent contractor exception if they do not provide investment advisory services or effectively control the finances or operations of one of the service recipient's lines of business.[28]

Testing date. An entity should be tested to determine whether it is a nonqualified entity only at the end of the taxable year in which the service provider obtains a legally binding right to compensation, absent abuse.[29] If the Notice's approach of requiring multiple testing dates is included in regulations, guidance should be provided that addresses how mergers, reorganizations and other transactions resulting in the assumption of compensation liabilities affect entity status determinations.[30] If the taxable years of the service provider and service

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[24] *See* discussion under Parts II.C.1 and II.C.2.

[25] *See* discussion under Part II.C.4.

[26] *See* discussion under Part II.D.1.

[27] *See* discussion under Part II.D.2.

[28] *See* discussion under Part II.E.

[29] *See* discussion under Part II.G.1.

[30] *See* discussion under Part II.G.2.

recipient differ, testing should be made as of the end of the service recipient's taxable year ending within the service provider's taxable year.[31]

"Determinable" amount of compensation. Because of the adverse consequences of treating compensation as not "determinable" when there is no longer a substantial risk of forfeiture, we recommend rules for clarifying that stock-based compensation, foreign currency-linked compensation and certain illiquid assets are "determinable," and for taking partly determinable amounts into account.[32] We also recommend that taxpayers be permitted to elect to take nondeterminable amounts into income (*cf.* Section 83(b)), subject to the additional taxes imposed by Section 457A(c) to the extent that the actual compensation exceeds the previously included amount, and with a full deduction to the extent such inclusion exceeds the actual compensation.[33]

Loss following prior income inclusion. If an amount is required to be included in income under Section 457A before the amount is actually paid to the service provider and such amount is subsequently forfeited, taxpayers should be able to reduce their adjusted gross income by the full amount of loss even if they elect not to itemize deductions or are subject to the alternative minimum tax.[34]

b. Recommendations Relating to International Tax Issues

Plan sponsor. The determination of whether an entity is a plan sponsor should be determined by reference to whether it is actually entitled to deduct the compensation under foreign law, rather than whether it would hypothetically be entitled to deduct it under U.S. tax principles.[35] Consistent with this recommendation, it should not matter whether the entity is a reverse hybrid or a branch.[36] If there are multiple plan sponsors, and one is a nonqualified entity, Section 457A should only apply with respect to the portion of nonqualified deferred compensation allocable to that nonqualified entity.[37]

Reimbursement arrangements. Special rules should apply in a case where the timing and amount of a reimbursement payment from a nonqualified entity is directly linked to the nonqualified deferred compensation owed by a domestic service recipient to a U.S. service provider – typically, where an employee of the domestic entity has provided services to the nonqualified entity. The Service should define the types of reimbursement arrangements subject to these special rules, which we believe should only include reimbursement arrangements where there is a direct correlation between the amount of the reimbursement payment and the

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[31] *See* discussion under Part II.G.3.

[32] *See* discussions under Part II.H.1 and II.H.2.

[33] *See* discussion under Part II.H.3.

[34] *See* discussion under Part II.H.4.

[35] *See* discussion under Part III.A.1.

[36] *See* discussion under Part III.A.2.

[37] *See* discussion under Part III.A.3.

compensation payment to the service provider.[38] If the reimbursement arrangement is between affiliates, the U.S. intermediary should be subject to rules that treat it as, or put it in a position similar to being, a mere conduit.[39] If the reimbursement arrangement is between third parties, Section 457A should apply to amounts the nonqualified entity owes to the U.S. intermediary, and not to the deferred compensation the domestic entity owes to the service provider.[40]

Treaty eligibility. Treaty eligibility for a plan sponsor should be determined without regard to whether the entity satisfies the relevant treaty's limitation of benefits ("LOB") requirements, because those limitations generally have no bearing on whether the entity is taxed by the treaty country and enjoys the benefit of a compensation deduction, which should be the key to nonqualified entity determinations. However, in order to insure that the entity is likely to actually have taxable income, a limited form of base erosion test should apply.[41] If Treasury and the Service believe that LOB provisions must be taken into account, we propose a modified application of the so-called trade or business LOB clause of the treaty to deal with the fact that a foreign company may not have U.S. source income.[42]

Tax system test. The Service should publish a list of countries that have a comprehensive income tax, or a list of relevant factors that enables taxpayers to determine which countries qualify. A treaty jurisdiction should be treated *per se* as a country with a comprehensive income tax. If the Service instead prefers to issue private letter rulings, detailed guidance will be necessary as to the process and the required information.[43] In either case, an entity should not be required to be a resident of the country where it is subject to a comprehensive foreign income tax.[44]

"Substantially all" test. While the Notice is generally helpful in providing clear guidance that certain foreign corporations will not be nonqualified entities, a foreign corporation that fails to meet the Notice's fairly stringent standards should not necessarily be treated as a nonqualified entity. We recommend that the 80 percent test in Q&A-8 of the Notice be adopted as a safe harbor, rather than an absolute requirement, and alternative qualitative tests also be made available. These qualitative tests might consider such factors as whether the 80 percent test would be met if applied to the corporation's average income over a three-year period, whether certain excluded nonresidence source income relates to an extraordinary transaction or unexpected event, or whether substantially all of the corporation's operating income was subject to a comprehensive tax.[45]

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[38] *See* discussion under Part III.B.1.

[39] *See* discussion under Part III.B.2.

[40] *See* discussion under Part III.B.3.

[41] *See* discussion under Part III.C.1.

[42] *See* discussion under Part III.C.2.

[43] *See* discussion under Parts III.D.1.

[44] *See* discussion under Part III.D.3.

[45] *See* discussion under Part III.F.

Excluded income. We recommend that the definition of excluded income be narrowed, so that its focus is on income that is not treated as gross income, rather than on whether the income is eligible for, for example, foreign tax credits, dividends paid deductions or other deductions.[46] (Such issues should, however, be relevant for purposes of determining whether the entity is subject to a materially more favorable tax regime.) Income of a reverse hybrid or a branch should be treated as income earned by a corporation for this purpose.[47] Since the test is applied by reference to foreign tax law rules, the scope of U.S. tax principles (i.e., gross income as defined under Section 61) should be very limited.[48] We include in our "Detailed Report" a recommended list of additional exceptions to the calculation of the excluded amount.[49]

Materially more favorable tax regimes. A "materially more favorable tax regime" generally should mean a tax regime applicable to an entity with special tax status, and should not take into account favorable rules of a kind generally available to U.S. taxable corporations.[50] If only a portion of an entity's income is subject to a materially more favorable tax regime, the plan sponsor should not be treated as nonqualified as long as substantially all of its income is not subject to the regime. Guidance should address how to apply the test to non-corporate entities.[51]

Controlled group aggregation rules. We recommend that guidance clarify that mandatory aggregation rules should not apply at all, unless an entity is part of a consolidated or combined group under foreign law. We further recommend that plan sponsors may optionally elect into an aggregation regime, either on a same-country or worldwide basis.[52]

c. Recommendations Relating to Partnership Tax Issues

Compliance and reporting. Given a partnership's lack of access to information about indirect partners, the potential administrative burden and legal judgment that would be required of partners to produce the relevant information, the understandable reticence of partners to deliver this information, and the inability of the Service to effectively enforce reporting requirements imposed on foreign persons, we believe the Service should develop a questionnaire that partners can complete based on reasonable belief, not under penalties of perjury, and without independent knowledge of Section 457A rules.[53] Under a three-tier system similar to that proposed for foreign corporations, certain service providers should be able to rely in good faith on this limited information reporting, and should be able to make certain simplifying

46 *See* discussion under Part III.E.1.

47 *See* discussion under Part III.E.2.

48 *See* discussion under Part III.E.3.

49 *See* discussion under Part III.E.4.

50 *See* discussion under Part III.G.1.

51 *See* discussion under Part III.G.3.

52 *See* discussion under Part III.I.

53 *See* discussion under Part IV.A.

presumptions in the event their partners do not provide such information, absent knowledge of objective indicia that such information reporting or simplifying presumptions are incorrect.[54]

Allocation of net income and gross compensation expense. While the statute refers to income allocations, we believe Treasury and the Service should look to net income allocations rather than gross income allocations. Because compensation expense is generally deemed allocated based on allocations of residual net income, and because Section 457A's legislative history indicates Congress was worried about situations where the compensation would not be deductible against comprehensive taxes, Treasury and the Service should provide a safe harbor that would treat a partnership as meeting the "substantially all" income test if at least 80 percent of the partnership's gross compensation expense attributable to nonqualified deferred compensation would be allocable to eligible persons.[55]

Calculation of "gross income". If Treasury and the Service continue to look towards allocations of gross income, the plan sponsor should be able to rely on book income for these purposes. In any event, special regulatory adjustments should be ignored.[56]

Guaranteed payments and Section 736 payments. Guaranteed payments that are not the substantial equivalents of salary (e.g., guaranteed payments based on partnership items and not fixed payments or based on a formula related solely to items outside the partnership) should be excluded from Section 457A.[57] Section 736 payments should also be excluded from Section 457A, regardless of whether or not they are exempt from SECA tax.[58]

Anti-deferral regimes. Foreign partners that include partnership income in their taxable income on a current basis as a result of an anti-deferral regime should be treated as eligible persons with respect to such partnership income.[59]

Allocations of partnership income to partnerships. We commend the Notice on providing that a plan sponsor that is a partnership may allocate income to itself to the extent such partnership is treated under the laws of a foreign country as resident in that country and is subject to such country's comprehensive income tax. Treasury and the Service should extend this same principle to partnerships subject to a comprehensive foreign income tax as permanent establishments, even if they are not treated as "residents" of such country. Treasury and the Service should also clarify that a plan sponsor can allocate income to a direct or indirect partner that is also a partnership for U.S. tax purposes, provided it is subject to a comprehensive foreign income tax with respect to such income.[60]

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54 *See* discussion under Part IV.A.3.

55 *See* discussion under Part IV.B.1.

56 *See* discussion under Part IV.B.3.

57 *See* discussion under Part IV.C.1.

58 *See* discussion under Part IV.C.2.

59 *See* discussion under Part IV.E.

60 *See* discussion under Part IV.E.

Income exclusions and eligible persons. Because the partnership test looks to whether the income is subject on a current basis to a comprehensive foreign income tax that is imposed on someone, somewhere, the residence of the direct or indirect partner should not be required to match the jurisdiction imposing the tax. In particular, a partner should be treated as an eligible person with respect to partnership income that is treated as excluded by the partner's jurisdiction of residence, provided the partner is taxed currently on such income by another jurisdiction pursuant to its comprehensive foreign income tax (for example, under a foreign income tax analogous to the U.S. tax on ECI).[61]

d. Recommendations Relating to the Investment Asset Exception

Application to typical "side pocket" arrangements. To the extent possible under the statute, Treasury and the Service should interpret the investment asset exception such that it would apply to certain "side pocket" arrangements that are standard in the marketplace.[62] In particular:

- netting should be allowed for mass assets (such as pools of credit card receivables or related plots of land),[63]
- the amount of gain recognized on disposition should be interpreted as including net profits that are not capital gains,[64]
- assets should be treated as "acquired directly" even if intermediary vehicles are used for the acquisition,[65] and
- management rights similar to shareholder voting rights should not constitute "active management" of the asset.[66]

"Mini-master" structures. Interim guidance should clarify that the restructuring of existing side pocket arrangements as "mini-master" partnerships will be respected, and interests in such mini-master partnerships will not be treated as nonqualified deferred compensation for purposes of Section 457A.[67]

e. Recommendations Relating to Transitional Issues

Amendment of cash-settled SARs. To the extent Treasury and the Service do not adopt our recommendation to exclude cash-settled SARs from Section 457A (and in any event in the interim period), existing SARs that are amended to provide for settlement exclusively in stock

[61] *See* discussion under Part IV.E.

[62] *See* discussion under Part V.B.

[63] *See* discussion under Part V.B.1.

[64] *See* discussion under Part V.B.2.

[65] *See* discussion under Part V.B.3.

[66] *See* discussion under Part V.B.4.

[67] *See* discussion under Part V.C.

should not be considered nonqualified deferred compensation under Section 457A, even if the amendment is effected unilaterally by the party with discretion to choose the method of settlement.[68]

Grandfathered amounts that are payable after 2017. As it may be practically impossible for a service provider to determine whether a plan sponsor was a nonqualified entity in any period prior to the enactment of Section 457A, or to determine the appropriate allocation with respect to such prior periods of the service provider's deferred compensation amongst different members of a multinational group, we recommend allowing service providers to use any reasonable method for making such determinations.[69]

Determining the period of service to which compensation is attributable. Where a substantial risk of forfeiture lapses on a date that is based on a future event and there is no certainty as to when such event will occur, the payment should be attributed to the year in which the employee obtains a legally binding right to the compensation. Consequently such arrangements should be grandfathered if entered into prior to the effective date of Section 457A, even if the compensation is subject to a substantial risk of forfeiture after such effective date. Similarly, pre-existing side pocket arrangements should be grandfathered (regardless of whether they qualify for the investment asset exception).[70]

Extension of transition relief. Considering the practical difficulties involved in altering previously negotiated compensation agreements, and the legal complexities that arise in interpreting Section 457A's scope, we urge Treasury and the Service to extend the transitional relief period that ended on July 1, 2009 to no earlier than June 30, 2010.[71]

Additional transition relief. In many situations, the plan sponsor or its owners will not be amenable as a business matter to the acceleration of vesting. Accordingly, Treasury and the Service should consider allowing service providers to make an election to include the fair market value of their rights to deferred nondeterminable amounts in income immediately without imposing interest penalties or the 20 percent additional tax, if such rights were legally binding prior to the effective date of the statute.[72]

C. Comparison of Section 457A and Section 409A

This Report assumes in part that readers have a basic understanding of Section 409A. As will be seen from the remainder of the Report, Section 457A borrows a number of concepts from Section 409A. However, Section 457A also differs in significant part from Section 409A. When Section 409A was introduced into the law, it took practitioners and taxpayers some time to familiarize themselves with the new concepts introduced by the statute. Some of the frustration caused by Section 457A is the fact that while it uses similar terms as Section 409A, it is targeted

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68 *See* discussion under Part II.B.2.

69 *See* discussion under Part VI.A.1.

70 *See* discussion under Part VI.A.2.

71 *See* discussion under Part VI.B.1.

72 *See* discussion under Part VI.B.2.

at a very specific group of payors of deferred compensation and as a result there are certain important differences between these two statutory frameworks. This makes relying on the more established framework under Section 409A sometimes difficult.

The following paragraphs provide a brief overview of Section 409A and the main differences between it and Section 457A.

Section 409A imposes strict restrictions on the time and form of payment of nonqualified deferred compensation by any payor (a "service recipient," typically an employer) to a recipient (a "service provider," typically an employee), subject to certain exceptions specified in Section 409A and the regulations thereunder. Generally, Section 409A requires all nonqualified deferred compensation to which it applies to be paid out under a fixed schedule or on the occurrence of certain specified permissible distribution events. Any payments of nonqualified deferred compensation (as defined under Section 409A) that do not satisfy these requirements are subject to tax on the deferred compensation at the time that there is no substantial risk of forfeiture, plus interest on deferred amounts at the underpayment rate plus 1 percent, plus an additional 20 percent additional tax.

Section 409A also includes a concept of "aggregation" of deferred compensation plans, such that a violation of the rules with respect to a single payment in one plan can affect all payments to the affected service provider under all plans of the same type (as described in the plan aggregation rules) and cause the aggregated payments to be immediately included in income with interest and the additional 20 percent tax, as described above.[73]

Among the most important exceptions to these rules are: (i) Section 409A applies only to cash method service providers (presumably under the view that an accrual basis taxpayer generally cannot defer recognition beyond the occurrence of the "all events" test); (ii) Section 409A has an exclusion for certain "independent contractors"; and (iii) "short-term deferrals" (that is, compensation that is always paid out within 2 ½ months of the later of the end of the taxable year of the service provider or the service recipient in which the amount is no longer subject to a substantial risk of forfeiture) are excluded from the definition of nonqualified deferred compensation and exempt from the rules.

The main differences between Section 457A and Section 409A are:

- Section 409A applies to compensation paid by any person, while Section 457A applies only to compensation paid by a "nonqualified entity."

- Section 409A applies only to cash method service providers, while Section 457A applies to any service provider without regard to its method of accounting.

[73] The plan aggregation rules set forth in the final regulations under Section 409A establish nine separate categories of nonqualified deferred compensation; a Section 409A violation with respect to compensation in one category will affect all other nonqualified deferred compensation within that category for the affected service provider, but not amounts in the other categories. *See* Preamble to Final regulations, TD 9321, 72 Fed. Reg. 19249-19250 and Treasury regulations Section 1.409A-1(c)(2)(i).

- Section 409A permits compensation to be deferred beyond the vesting date as long as the deferral arrangement complies with the rules. Section 457A generally does not permit deferral beyond the time that the compensation is no longer subject to a substantial risk of forfeiture.

- A service provider under Section 409A will be subject to the 20 percent additional tax upon failure to comply with Section 409A. A service provider subject to Section 457A will be subject to the 20 percent additional tax and underpayment penalty to the extent the amount of compensation is not "determinable" at the time the substantial risk of forfeiture lapses. Thus, an analysis under Section 457A turns in significant part on whether or not the amount of compensation is "determinable" at the time there is no substantial risk of forfeiture, which is not a relevant concept under Section 409A.

- Section 457A defines "nonqualified deferred compensation plan" by cross-reference to Section 409A(d), although it also includes any plan that includes a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient. This covers SARs, which are exempt from Section 409A as long as specified requirements are met. As a result, Section 457A applies to some arrangements that have substantially similar economic effects as other arrangements that are exempted.

- Section 457A defines "substantial risk of forfeiture" with statutory language very similar to that used in Section 409A, but not by cross-reference.[74] The regulations under Section 409A have expanded the definition of substantial risk of forfeiture to include entitlements conditioned on the occurrence of a condition related to the purpose of the compensation (i.e., a contingency based on a business goal of the service recipient). One obvious example of this sort of condition would be a substantial risk of forfeiture tied to receipt of a certain level of profits. For purposes of Section 457A, "substantial risk of forfeiture" does *not* include such conditions even if the possibility of the risk of forfeiture is substantial.

- Section 409A exempts from treatment as nonqualified deferred compensation a payment that by its terms must be made within 2 ½ months after the later of the end of the taxable year of the service recipient or the end of the taxable year of the service *provider* in which there is no longer a substantial risk of forfeiture. Section 457A has a similar concept (subject to the narrower definition of substantial risk of forfeiture as described above) but allows a payment not later than twelve months after the end of the taxable year of the

[74] Section 457A provides that rights to compensation are treated as subject to a substantial risk of forfeiture *only* if such person's rights to compensation are conditioned upon the future performance of substantial services by any individual. Section 409A has the same language, without the "only."

service *recipient* during which the right to payment is no longer subject to a substantial risk of forfeiture.[75]

Section 409A and Section 457A are motivated by different concerns, and this can cause them to pull in different directions. Section 409A generally attempts to prevent acceleration of certain payments (i.e., Section 409A is a compliance statute), while Section 457A generally attempts to prevent income deferrals or penalizes them. As the Notice recognizes, inclusions mandated under Section 457A should not trigger Section 409A penalties. However, there are also circumstances that may not be covered by the Notice because Section 457A will not clearly apply, but the potential threat of Section 457A will impel inclusion or payment of compensation that would otherwise have been deferred. Coordination with Section 409A is particularly important in such situations.

The remainder of this report identifies the areas where we believe that either further guidance is needed or where the existing guidance provided in the Notice should be supplemented or amended and offers recommendations relating to such guidance. We have divided our discussion into five parts: the first part sets forth issues relating to the employee benefits aspect of Section 457A and its overlap with Section 409A; the second part addresses issues primarily relating to the determination of the nonqualified entity status of a plan sponsor and the meaning of the term "comprehensive foreign income tax" as provided in the statute and interpreted in the Notice; the third part describes issues relating to the application of Section 457A to plan sponsors that are partnerships for U.S. tax purposes; the fourth part discusses the investment asset exception; and the last part discusses transitional issues.

II. Nonqualified Deferred Compensation Issues

A. Service Provider Compliance

Background

Service providers are generally responsible for determining if a plan sponsor is a nonqualified entity under Section 457A. As such, service providers are subject to Section 457A (including interest and penalties) regardless of whether or not they are in a managerial or other influential position, or have access to the information needed to evaluate the plan sponsor's status. In the context of foreign corporations, these compliance issues are exacerbated by the fact that foreign corporations (unless they are subject to U.S. tax-return filing requirements) cannot generally be subjected to any reporting obligations. This information imbalance is potentially even more problematic in the case of partnerships (whether domestic or non-U.S.), where it is possible that neither the service provider nor the partnership itself have comprehensive knowledge of who the indirect partners are or how income is allocated amongst them.

[75] The Notice expanded the application of the Section 409A short-term deferral rule to Section 457A. *See* Notice Q&A-4.

Proposal

We suggest that Treasury and the Service should address practical considerations regarding information collection and resulting fairness concerns by (i) exempting service providers receiving deferred compensation below a threshold (to be determined by Treasury and the Service) from the application of Section 457A, (ii) allowing service providers who receive nonqualified deferred compensation in excess of the threshold, but who lack the authority or access to information to determine if the plan sponsor is a nonqualified entity, to rely on the information they can obtain from the plan sponsor through good-faith efforts, and (iii) requiring full compliance with Section 457A from service providers who receive nonqualified deferred compensation in excess of the threshold and who are expected to have the authority and clout needed to obtain the information required for them to make a nonqualified entity determination.

Discussion

Section 457A's requirement that each service provider determine whether or not their plan sponsors are nonqualified entities seems effectively to assume that service providers possess a certain level of influence and authority over plan sponsors. In most cases, service providers who receive a relatively small amount of deferred compensation will not be in positions of authority or influence, and as such, they are not likely to be equipped to determine if their plan sponsor meets the requirements of Section 457A. This same lack of authority and influence may mean that the service provider is not in a position to greatly influence the form of compensation received, or impact the structure of the plan sponsor, thereby greatly decreasing the potential for the service providers to engage in the types of behavior which motivated the passage of Section 457A.

We propose service providers who receive nonqualified deferred compensation below a threshold amount be exempt from Section 457A altogether (hereinafter "lower-tier" service providers). If this proposal is adopted, then our proposal regarding reporting requirements for service providers (discussed at Parts III.H.1 and IV.A.1) should be modified to exempt entities, all of whose U.S. taxpayer service providers receiving nonqualified deferred compensation meet this exception, from the proposed plan sponsor level information reporting requirements.

Service providers who receive nonqualified deferred compensation above the threshold amount and do not qualify for this exception may still have difficulty meeting their Section 457A obligations if they occupy positions lacking access to relevant information or the authority necessary to persuade the plan sponsor to provide any information at all (hereinafter, "middle-tier" service providers). As a related matter, it will be difficult as a practical matter for the Service to audit lower-tier or middle-tier service providers, since neither the service provider nor the auditor generally will have sufficient information to properly establish whether Section 457A applies to a given compensation arrangement. We propose that taxpayers in this middle tier should be obligated to make a good-faith effort to find out if the plan sponsor is nonqualified, for example, by making a written request for the relevant information, and should be subject to Section 457A if they know or have reason to know the plan sponsor is nonqualified (for example, if they know the plan sponsor is organized and operates in a jurisdiction without a comprehensive foreign income tax, or that the plan sponsor is a fund with primarily tax-exempt investors). If the plan sponsor provides these service providers with information regarding its

status, they should be able to rely on such information even if it later turns out that the plan sponsor made the nonqualified entity determination incorrectly, and should not be required to provide the Service with any further information pertaining to whether the plan sponsor was nonqualified on audit.

In addition, service providers who receive nonqualified deferred compensation in excess of the threshold amount described above, and who have the most managerial authority, access to information, or power to influence the actions of the plan sponsor, should be required to comply fully with the requirements of Section 457A (hereinafter, "higher-tier" service providers). Such "higher-tier" service providers would include (i) those with managerial authority, (ii) those personally and materially involved in performing the analysis of the plan sponsor's status, (iii) significant direct or indirect owners of the plan sponsor, and (iv) certain key employees. (Regarding the standards for the foregoing clauses (iii) and (iv), Treasury and the Service may wish to be guided by principles applicable to the determination of "key employees" under Section 416.) We believe that this top tier contains the service providers that motivated Congress in adopting Section 457A, as these types of service providers are most able to influence a plan sponsor to provide them with nonqualified deferred compensation in potentially abusive situations. These service providers can also reasonably be expected to be capable of providing the Service sufficient information (and documentation) about the plan sponsor on audit to demonstrate that said sponsor was subject to a comprehensive income tax.

As discussed in more detail in Part IV.A.3, an exception should be made for members of this third group of service providers when they are receiving compensation from partnership plan sponsors, due to the difficulties that even a highly placed service provider may encounter in obtaining information regarding the membership and income allocations for the partnership and any direct and indirect partners. In this case, the providers should be permitted to rely in good faith on the information they receive from the plan sponsor's direct and indirect partners, to the extent that they do not know or have reason to know the information is false.[76] For example, such service providers should be able to rely on a statement by a partner that is an entity that such partner is itself not a nonqualified entity, without being required to make an inquiry into the income allocations of such higher-tier partnership.

In calculating compensation amounts for the purposes of this test, appropriate aggregation rules should apply to determine the amount of a service provider's compensation, so that a service provider cannot avoid Section 457A by structuring their compensation so that affiliated service providers each receive an amount of deferred compensation below the threshold, or so that affiliated plan sponsors each pay an amount of deferred compensation below the threshold.

While we believe that in an ideal world distinctions would not have to be drawn among service providers in this manner, this proposal has been made in order to mitigate what we perceive to be significant practical problems that will arise in the application of Section 457A to lower-tier and middle-tier service providers. We believe that Treasury and the Service have

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[76] "Higher-tier" service providers may be deemed to have "reason to know" all information available to the plan sponsor.

authority to implement such a proposal (e.g., in the definition of "service provider"), much as Treasury and the Service have authority to exclude independent contractors.

B. Definition of Plan

Very generally, a plan that does not provide compensation of a kind that is considered deferred compensation is outside the scope of Section 457A. This Part II.B discusses a number of issues affecting whether there is a "plan" potentially subject to Section 457A.

1. Cash-Settled SARs Should Be Excluded from Section 457A

Background

Section 457A(d)(3)(A) includes in the definition of nonqualified deferred compensation plan "any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient." Accordingly, the legislative history provides that SARs will be treated as nonqualified deferred compensation under Section 457A regardless of the exercise price of the SAR.[77] Nevertheless, the Notice exempts a SAR from Section 457A if, by its terms, it at all times must be, and is, settled in service recipient stock, and otherwise satisfies the requirements for exception from coverage under Section 1.409A-1(b)(5)(i)(B) of the Treasury regulations.[78]

Section 1.409A-1(b)(5)(i)(B) of the Treasury regulations generally provides that a SAR is exempt from Section 409A if (i) compensation payable under the SAR cannot be greater than the excess of the fair market value of the stock on the date the SAR is exercised over an amount specified on the date of grant of the SAR (i.e., the exercise price), with respect to a number of shares fixed on or before the date of grant of the right; (ii) the exercise price may never be less than the fair market value of the underlying stock on the date the right is granted; and (iii) the SAR does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the SAR. Importantly, the exception under Section 1.409A-1(b)(5)(i)(B) of the Treasury regulations applies to both stock-settled and cash-settled SARs that meet the foregoing requirements.

Proposals

We recommend that cash-settled SARs be excluded from Section 457A coverage on the same basis as stock-settled SARs. Should this relief not be granted, we alternatively recommend that the following should be excluded from Section 457A coverage: (1) SARs relating to stock of publicly traded companies and (2) SARs which are, or may be, settled in cash (i) in connection with change in control transactions or other business combinations or (ii) in order to satisfy applicable tax withholding requirements. To the extent that Treasury and the Service do not believe they have the authority to make such change, we recommend that Treasury and the Service support a technical correction addressing this issue.

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[77] *See*, e.g., Blue Book at 529.

[78] Notice Q&A-2(b).

Discussion

Although a significant departure from the statutory provision treating plans that provide a right to compensation based on the appreciation in value of a specified number of equity units as subject to Section 457A, the exception for stock-settled SARs in the Notice is consistent with the exception noted in the legislative history for transfers of property subject to Section 83 as the taxation of transfers of stock in connection the settlement of SARs is generally governed by Section 83. Presumably (and we believe appropriately), Treasury is relying upon its general authority under Section 457A(e) to prescribe such regulations that are necessary or appropriate to carry out the provisions of Section 457A as its basis for excluding stock-settled SARs that otherwise meet the requirements of Section 409A from Section 457A coverage.

As noted in the preamble to the proposed regulations to Section 409A, a SAR can be the economic equivalent of a stock option, especially a stock option that allows the holder to exercise in a manner other than by the payment of cash (a cashless exercise feature). Similarly, stock-settled and cash-settled SARs will yield economically equivalent results where the stock acquired pursuant to the exercise of the stock-settled SAR is immediately sold for cash. The economic equivalence is particularly stark with respect to service recipient stock, which is publicly traded. Consequently, we do not believe the distinction between cash-settled and stock-settled SARs is meaningful or relevant from an economic perspective.

Under existing law, the income tax consequences of SARs are governed by Section 451 and the doctrine of constructive receipt and, unless exempt from coverage, Section 409A. Revenue Ruling 80-300, amplified by Revenue Ruling 82-121, provides that the forfeiture of a valuable right is a substantial limitation that precludes constructive receipt of income. In the case of a SAR, the employee's right to benefit from further appreciation of the stock without risking any capital is a valuable right.[79] As a result, the holder of a SAR will not be in constructive receipt of income by virtue of the appreciation of the underlying stock.[80] Rather, the holder of a SAR will recognize income with respect to the SAR for the year in which the SAR is exercised. This result is the same for cash-settled and stock-settled SARs, although, as noted above, the taxation of the transfer of stock in connection with the exercise of the stock-settled SAR would be governed by Section 83. The amount of income generated upon exercise of a stock-settled SAR is identical to that generated upon exercise of an economically equivalent cash-settled SAR.

In addition to the exception to coverage available for SARs under Section 409A, other Code provisions do not distinguish between cash-settled and stock-settled SARs for any purpose. For example, cash-settled and stock-settled SARs receive special treatment under Section 162(m) if they are granted with a fair market value exercise price. Treasury regulations under Section 163(m) state that SARs are treated as satisfying the performance goal requirement of Section 162(m) if "the amount of compensation the employee could receive is based solely on an

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[79] *See*, *e.g.,* Priv. Ltr. Rul. 8949032 (Sept. 8, 1989).

[80] Priv. Ltr. Rul. 8642025 (July 16, 1986) states that the need to forfeit the right to future appreciation on the stock to which the SAR relates will be a substantial limitation that precludes constructive receipt of income from appreciation of the stock, prior to exercise of the SAR, provided that the base price of the SAR is equal at least to the fair market value of the stock at the grant date of the SAR.

increase in the value of the stock after the date of the award."[81] Similarly, Section 3121(v)(2) exempts cash-settled and stock-settled SARs from the definition of nonqualified deferred compensation.[82]

We understand that Treasury and the Service may be concerned (in the context of Section 457A) that manipulation of stock valuations, and manipulation of the characteristics of the underlying stock, may lead to abuses with respect to cash-settled SARs. We note, however, that the opportunity for such abuses does not appear to be greater than the potential for such manipulations involving stock-settled SARs that are exempted from Section 457A coverage. Moreover, the opportunity for such abuses have been addressed by Treasury and the Service by the more stringent standards applicable to the identification of service recipient stock that may be subject to, or used to determine the amount payable under, stock rights, and the valuation of such service recipient stock, which were adopted as part of the final Section 409A regulations and which also apply for Section 457A purposes. Therefore, we do not believe such concerns would justify a decision to not extend the stock-settled SAR exclusion from Section 457A coverage to cash-settled SARs. Further, we believe the opportunity of any abuses of this type is small or nonexistent with respect to SARs relating to stock of publicly traded companies.

Additionally, we note that there are significant non-tax reasons why service recipients may prefer to use cash-settled SARs over stock-settled SARs. First, private or closely-held companies may find cash-settled SARs more desirable as a means to restrict ownership of their stock to certain persons. Second, cash-settled SARs may be preferable in jurisdictions where the use of stock-settled SARs may not be feasible or may be inappropriate due to local laws or practices. If all cash-settled SARs were subject to Section 457A, this would effectively eliminate the ability to use cash-settled SARs in these situations due to the adverse tax consequences that would result under Section 457A.

Finally, if Treasury and the Service determine that cash settled SARs should not be fully exempt from Section 457A on the same basis as stock-settled SARs, we believe this relief would, in any case, be appropriate for cash settled SARs relating to stock of publicly traded companies where opportunities for manipulation of stock characteristics and valuation are minimal and where the distinction between stock and cash settled SARs has the least amount of economic consequence. In any event, the rigid requirement that exempt SARs be settled for stock in all instances should be relaxed to accommodate cash-outs of outstanding SARs in connection with change in control transactions or other business combinations to avoid an unnecessary and potentially burdensome impediment to commercial transactions with independent third parties (particularly in transactions where the underlying stock of the service recipient is converted to cash or other property (excluding stock)), given the extremely low likelihood that such relief could result in abusive arrangements that Section 457A is intended to curtail. Additionally, future guidance should confirm that a feature or arrangement allowing an employer to withhold stock subject to a stock-settled SAR, or an employee to tender previously-owed shares of stock, in either instance, to satisfy required tax withholding obligations associated with the exercise of a stock-settled SAR would not cause such SAR to be subject to Section 457A. Such relief would

81 Treasury regulations Section 1.162-27(e)(2)(vi)(A).

82 Section 3121(v)(2); Treasury regulations Section 31.3121(v)(2)-1(b)(4)(ii).

facilitate an employer's ability to satisfy applicable tax withholding requirements without unduly burdening SAR holders who may lack sufficient liquid funds to satisfy applicable tax withholding obligations. We do not believe such relief would lead to abuses.

Accordingly, we recommend that cash-settled SARs be excluded from Section 457A coverage on the same basis as stock-settled SARs. Should this relief not be granted, we alternatively recommend that the following should be excluded from Section 457A coverage: (1) SARs relating to stock of publicly traded companies and (2) SARs which are, or may be, settled in cash (i) in connection with change in control transactions or other business combinations or (ii) in order to satisfy applicable tax withholding requirements.

Our proposal would not render the statutory language superfluous. First, the proposed exception would be limited solely to SARs that meet the requirements of Treasury regulations Section 1.409A-1(b)(5)(B). Therefore, SARs that do not satisfy these requirements, such as discount SARs (i.e., SARs with an exercise price that is less than the fair market value of the underlying stock) or SARs that include a feature for the deferral of compensation (other than the deferral of income recognition until exercise), would be subject to the express statutory language under Section 457A(d)(3)(A) that includes "any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient" in the definition of "nonqualified deferred compensation plan" under Section 457A (unless another exception applies). Second, in light of the relevance of concepts under Section 409A, there could be a change to the approach under Section 409A increasing flexibility, which Treasury would not want to respect for purposes of Section 457A. For example, there could theoretically be some Section 409A relief for discount SARs, and Treasury might nevertheless not want to extend that relief to Section 457A. The statutory language, which provides a rule notwithstanding what the rule might be under Section 409A, would be a basis for that approach. Third, there are many instruments in the nature of an "equity unit" that may not be SARs (SARs only provide for rights in respect of appreciation of the underlying equity, which is by no means universal to all equity awards), some of which may not be deferred compensation for purposes of Section 409A (e.g., because they are Section 409A short-term deferrals), but which Treasury may nevertheless believe should be subject to Section 457A. Examples could include instruments sometimes referred to as phantom units, restricted stock (or other) units and full-value awards. The statutory language would have continuing relevance in respect thereof. Finally, the statutory grant of regulatory authority under Section 457A(e) is extremely broad, and we believe that it is within Treasury and the Service's discretion to interpret the definition of "nonqualified deferred compensation" in light of practical considerations, if they believe that doing so would be consistent with the administrability of the statute and the underlying legislative policy.

2. Transition Rule for Cash-Settled SARs

Proposal

We believe that a transition rule should permit an amendment of a current SAR to provide for settlement exclusively in stock. The amendment should be able to be effected by unilateral agreement of (i) the service recipient, in those cases in which the service recipient has discretion as to whether to settle in stock, and (ii) of the service provider, in those cases in which

the service provider has such discretion. In light of the harsh consequences of a failure to observe this rule, and the uncertain policy basis therefore, we believe that the transition period should be generous, and should extend until the earlier of (i) exercise of the SAR and (ii) the end of the calendar year to follow the calendar year in which the relief is provided by Treasury and the Service.

Discussion

It is not entirely clear under guidance issued to date whether a current outstanding SAR (which by its terms can be settled in cash or stock) can be amended to provide for settlement exclusively in stock. In contrast to the Section 409A rules, Section 457A(d)(3)(A) specifically provides that a "nonqualified deferred compensation plan" does include any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient. Under the Notice, in order for a SAR to be exempt from Section 457A consideration as nonqualified deferred compensation, it must, by its terms, permit settlement only in shares (not cash). This is a departure from the Section 409A rules, which permit the SAR to be settled in either cash or service recipient stock.

3. Rules for Service Recipient Stock Should be Extended to Non-Corporate Entities

Background

The Notice provides that taxpayers may rely on the applicable guidance under Section 409A with respect to an arrangement between a partner and a partnership.[83] Consistent with the legislative history, the Notice provides an exception from coverage under Section 457A for nonstatutory stock options that satisfy the requirements of Section 1.409A-1(b)(5)(i)(A) of the Treasury regulations. In this regard, the Notice states that "for purposes of applying the exception from coverage under Treasury regulations Section 1.409A-1(b)(5)(i)(A) to an equity interest in a non-corporate entity (meaning a right to purchase actual equity in such entity, and not a mere right to an amount equal to the appreciation in such entity), the rules of Treasury regulations Section 1.409A-1(b)(5)(i)(A) are applied by analogy." Although the Notice provides an exception from coverage for SARs that (i) are by their terms at all times must be settled in service recipient stock, and are settled in service recipient stock, and (ii) otherwise satisfy the requirements of Section 1.409A-1(b)(5)(i)(B) of the Treasury regulations, unlike nonstatutory stock options on equity interests in non-corporate entities, the Notice does not permit this exception to be applied to equity appreciation rights on equity interests in non-corporate entities by analogy.

Proposal

Until specific requirements applicable to non-corporate entities, such as partnerships and LLCs, are issued, we recommend that future guidance continue to reflect the same approach with respect to (i) arrangements between a partner and a partnership, and (ii) nonstatutory stock options to purchase equity interests in non-corporate entities. Additionally, we recommend that,

[83] Notice Q&A-2(b).

with respect to SARs on equity interests in a non-corporate entity, the rules of Section 1.409A-1(b)(5)(i)(B) of the Treasury regulations be applied by analogy until such time as specific requirements for non-corporate entities are issued.

Discussion

While we recognize that partnership and LLC arrangements raise unique issues, we believe there is no tax policy reason or legislative intent to limit the definition of service recipient stock to stock of corporate entities for purposes of applying the exception from coverage under Section 1.409A-1(b)(5)(i)(A) of the Treasury regulations to nonstatutory stock options. Similarly, with respect to equity appreciation rights, we believe there is no tax policy reason to limit the definition of service recipient stock to stock of corporate entities when applying the exception from coverage under Section 1.409A-1(b)(5)(i)(B) of the Treasury regulations to SARs. We believe nonqualified entities organized as partnerships or LLCs should be permitted to establish and utilize option and SAR arrangements for their service providers on the same basis and to the same extent as nonqualified entities that are foreign corporations.[84]

4. Transfers of Property Subject to Section 83 Should be Excluded from Coverage

Background

The legislative history provides that "nonqualified deferred compensation for purposes of this provision does not include a transfer of property to which Section 83 is applicable (such as a transfer of restricted stock), provided that the arrangement does not include a deferral feature."[85] The term "nonqualified deferred compensation plan" has the same meaning as under Section 409A(d) and Section 1.409A-1(a) of the Treasury regulations (subject to certain exceptions not relevant here).[86] A service provider's receipt of property does not constitute a "nonqualified deferred compensation plan" for purposes of Section 409A.[87] Similarly, a legally binding right to receive property in a future year, where the property will be substantially non-vested (as defined in Section 1.83-3(b) of the Treasury regulations) at the time of transfer of the property,

[84] We understand from statements made by Treasury officials that the exclusion of SARs with respect to non-corporate entities was intentional due to concerns that it could allow hedge funds (that are not corporations) to avoid the application of Section 457A. Because hedge funds utilize both corporate and non-corporate entities in their investment structures and thus are likely to be able to provide their employees with compensation in form of SARs on equity interests in corporate entities, we believe that the exclusion would not be effective to address this concern. (Notably, hedge fund deferrals of compensation generally apply solely to the "offshore" side of the investment structure, which is generally conducted through entities treated as corporations for U.S. tax purposes.) Moreover, we note that options on equity of non-corporate entities are permitted, which have economics identical to those of SARs. Accordingly, until such time as specific requirements for non-corporate entities are issued, we believe it would be appropriate to allow non-corporate entities to utilize SARs.

[85] *See* Blue Book at 529. The same language is also included in the H.R. 7060 JCT Explanation.

[86] Section 457A(d)(3)(A); Notice Q&A-2(a).

[87] Treasury regulations Section 1.409A-1(b)(6)(i).

does not constitute a nonqualified deferred compensation plan for purposes of Section 409A[88] (unless offered in conjunction with another legally binding right that constitutes a deferral of compensation).

Proposals

We recommend that it be clarified that (i) transfers of property to which Section 83 applies (such as a transfer of stock that is substantially non-vested (as defined in Section 1.83-3(b) of the Treasury regulations) are not covered by Section 457A, and (ii) a legally binding right to receive property in a future year, where such property will be substantially non-vested (as defined in Section 1.83-3(b) of the Treasury regulations) at the time of transfer, will not be treated as a "nonqualified deferred compensation plan" for purposes of Section 457A unless offered in conjunction with another legally binding right that constitutes a deferral of compensation.

Discussion

In view of the clear intent to exclude transfers of property subject to Section 83 articulated in the legislative history, we believe that future guidance should expressly exclude transfers of such property in order to eliminate the need for taxpayers and their advisors to navigate the complex regulatory framework under Section 409A to reach this conclusion.

Further, by virtue of Section 457A's incorporation of the definition of "nonqualified deferred compensation plan" from Section 409A(d), we believe that Section 457A should not apply to a legally binding right to receive property in a future year, where such property will be substantially non-vested (as defined in Section 1.83-3(b) of the Treasury regulations) at the time of transfer to the same extent as under Section 409A. Therefore, we recommend that future Section 457A guidance specifically provide that such legally binding rights are excluded from Section 457A coverage.

5. Plan Aggregation Rules

Background

Section 457A(d)(3) defines a "nonqualified deferred compensation plan" and provides in Section 457A(d)(5) that rules similar to the rules of paragraphs (5) and (6) of Section 409A(d) shall be applied. Paragraph (6) of Section 409A(d) provides that aggregation rules "similar to the rules of subsections (b) and (c) of section 414" shall apply. Neither the legislative history nor the Notice address plan aggregation rules.[89] Section 1.409A-1(c)(2) of the Treasury regulations addresses plan aggregation rules as applicable to a nonqualified deferred compensation plan under Section 409A. Section 1.409A-1(c)(2) of the Treasury regulations provides that all plans of a service provider are aggregated, by plan "type," with all other plans of such service provider, and are treated as a single plan. Plan "types" are (i) employee contribution account

[88] Treasury regulations Section 1.409A-1(b)(6)(ii).

[89] As discussed in Part III.I below, the Blue Book does contain a limited discussion of *entity* aggregation rules.

balance plans, (ii) employer contribution account balance plans, (iii) nonaccount balance plans, (iv) separation pay plans, (v) in-kind benefit plans (or reimbursement plans), (vi) split-dollar life insurance arrangements, (vii) modified foreign earned income arrangements, (viii) stock rights plans and (ix) "other" plans. Under Section 409A, one result of treating all plans of a "type" as a single plan is that a failure of a "plan" to comply in operation with Section 409A results in income inclusion (and possible penalties) with respect to all plans of that "type" maintained by the service recipient in which the service provider participates.

Proposal

We believe that the clearest reading of the statute is to apply the "principles" of Section 409A aggregation to Section 457A plans. In other words, Section 457A plans will be categorized into the same nine categories of plan "types." We also urge Treasury and the Service to clarify that the application of the plan aggregation rules is not intended to change the manner in which Section 457A would apply to a separate plan if it were not aggregated.

Discussion

Commentators have skirted discussion of the application of plan aggregation rules to Section 457A plan. Within each "type," plans are treated as a single plan for Section 457A purposes. We do not believe that the intent of the statute is to aggregate Section 457A plans with Section 409A plans. To the extent a plan is a Section 457A plan, a failure to comply with Section 457A does not necessarily translate into a failure to comply with Section 409A. We believe any failures should be compartmentalized and only those penalties that apply under the Section with respect to which the failure occurs, should apply. For example, an employer contribution account balance plan which provides for payment on a date certain which is after the date that the substantial risk of forfeiture lapses, would fail to meet the Section 457A requirements and would be taxed as regular income upon lapse of the substantial risk of forfeiture. If the amount of payment cannot be ascertained at that time (in Section 457A parlance, it is not "determinable"), then under Section 457A the amount would not be taxed until it is "determinable," but would then be subject to regular tax plus the 20 percent additional tax and interest that applies under Section 457A(c). However, such a plan would not necessarily fail to meet the requirements of Section 409A. Thus, for penalty application purposes, there is no "aggregation" which crosses over the Section 457A/409A line.

We further note, however, that it is not entirely clear what purpose the plan aggregation rules serve in the context of Section 457A (except, perhaps, to the extent Treasury and the Service adopt our recommendation regarding broad-based plans, described below in Part II.B.6).[90] In the context of Section 409A, one effect of the plan aggregation rule is that if one plan within one category fails to comply with the operational requirements of Section 409A (i.e., impermissible acceleration, etc.), all amounts that are not subject to a substantial risk of forfeiture and have not previously been included in income under all plans within the same category (even if the deferral of such amounts is in compliance with Section 409A) become includable in income and are subject to applicable penalties.

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[90] For example, if the definition of a broad-based plan will depend on counting participants in a plan for percentages and the amount of compensation owed to them.

In the context of Section 457A, deferred compensation of a nonqualified entity is includable in income when it is no longer subject to a substantial risk of forfeiture. This cannot be avoided through any deferral election or through providing payment on certain permissible distribution events. Even if plans are aggregated, however, the amounts required to be included in income should only be amounts that are no longer subject to a substantial risk of forfeiture and that have not previously been included in income. Because a taxpayer cannot avoid the inclusion in income of amounts that are no longer subject to a substantial risk of forfeiture, aggregating the plans should not change that result. Rather, Treasury and the Service should confirm that the aggregation rules are not intended to change the manner in which Section 457A would apply to a separate plan if it were not aggregated.

Example: A service provider is entitled to compensation under a nonqualified deferred compensation plan (Plan A1) that is subject to Section 457A; under the plan the compensation is payable in the taxable year in which it is no longer subject to a substantial risk of forfeiture. Assume that the service provider subsequently (when the substantial risk of forfeiture has not lapsed yet with respect to Plan A1) becomes entitled to compensation under an additional plan within the same category as Plan A1 (Plan A2) that does not meet the Section 457A substantial risk of forfeiture definition but which provides for payment based upon conditions related to the business goal of the service recipient. If Plans A1 and A2 are required to be aggregated and the amounts are treated as deferred under a single plan, are the amounts deferred under the Section 457A compliant Plan A1 includable in income when the service provider has a legal entitlement to compensation under Plan A2 because they are treated as deferred under one plan?

We believe the answer to this question should be no and recommend that Treasury clarify this in regulations.

6. Broad-Based Plan Exception

Background

The regulations under Section 409A exclude from the definition of "plan" certain broad-based foreign retirement plans.[91] This exception presumably applies as well to Section 457A, as a result of the Section 457A(d)(3) cross-reference to Section 409A generally for purposes of defining "plan" for purposes of Section 457A.[92]

The conditions for use of the "broad-based foreign retirement plan" exemption under Section 409A vary depending on the status of the U.S. individual. If the individual is a U.S. citizen or permanent resident (green card holder), then the individual must not be eligible to participate in a U.S. qualified plan, regardless of whether the individual actually participates in

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[91] Treasury regulations Section 1.409A-1(a)(3)(v). To be "broad-based" the plan must meet the following criteria: (1) the plan (alone or in combination with other comparable plans) covers a wide range of employees substantially all of whom are nonresident aliens, including rank and file employees; (2) the plan provides significant benefits to a substantial majority of such covered employees; (3) the benefits actually provided under the plan are nondiscriminatory; and (4) the plan has in-service withdrawal restrictions to discourage employees from using plan benefits for non-retirement purposes, with some limited exceptions.

[92] *See also* Notice Q&A-2(a), which refers (with certain exceptions) to Treasury regulations Section 1.409A-1(a) for purposes of the definition of the term "plan."

order to qualify for the exemption. Also, for U.S. citizens and permanent residents, the exemption applies only to nonelective deferrals of modified foreign earned income and only up to a certain threshold amount.[93] Individuals that are U.S. residents solely due to the substantial presence test of Section 7701(b)(1)(A)(ii) or are bona fide residents of one of the possessions of the United States, may accrue benefits under a broad-based foreign retirement plan (and not be subject to Section 409A) without the restrictions that are applicable to U.S. citizens and permanent residents.[94]

Proposal

We suggest that for operating companies a similar (but broader) exception would apply to exclude from Section 457A nonqualified deferred compensation pursuant to any plan (not just retirement plans) under which a substantial percentage of the participants and of the deferred compensation is payable to persons who are not U.S. taxpayers.[95]

Discussion

Many multinational business enterprises have established compensation plans that apply on a worldwide basis, including both U.S. and non-U.S. employing entities, and U.S. and non-U.S. participants. For compensation plans that have a substantial percentage of non-U.S. participants (by number), and a substantial portion of the deferred compensation payable to non-U.S. participants, it is unlikely that the U.S. tax implications of the compensation plan are a significant driver of the plan features, as contrasted to general commercial considerations. In such a circumstance the U.S. tax tension, or lack of tension, between service providers and service recipients is simply unlikely to be material. In addition, it would be desirable to limit the situations in which employers are forced to modify their deferred compensation arrangements to avoid adverse tax impacts on their U.S. employees, which as an unwelcome side effect requires them also to modify the compensation plans of many employees that are not subject to U.S. tax.

Consequently, we suggest that Treasury and the Service provide in regulations an exception for "broad-based" foreign plans of operating companies. The exception under Section 457A should apply to any type of nonqualified deferred compensation (not just retirement arrangements) and should apply to U.S. citizens and permanent resident without any of the limitations that apply under Section 409A in connection with the exception for broad-based foreign retirement plans.[96] This Report does not offer a definition of what constitutes an "operating company" for purposes of Section 457A (although see Part III.F for some

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[93] *See* Treasury regulations Section 1.409A-1(a)(3)(iii).

[94] *See* Treasury regulations Section 1.409A-1(a)(3)(ii).

[95] If Treasury and the Service do not accept our proposal for a broad-based plan exception, we encourage the exploration of exceptions, safe-harbors or other relief applicable to bona fide operating companies, in light of the underlying purposes of the statute and the extensive administrative burdens (including many with substantial extra-territorial effect) that Section 457A is likely to engender.

[96] Possibly temporary U.S. residents could also be counted as "U.S." participants for this purpose. We suggest counting only U.S. citizens and permanent residents to avoid the administrative difficulties of having employers have to count days spent in the United States, allocating income, determining the effect of tax treaty tie-breaker provisions, etc.

alternatives), nor suggest how "substantial" the participation of non-U.S. persons should be to cause the compensation arrangements to be treated as outside the scope of a "plan" of nonqualified deferred compensation; our suggestion is merely to consider implementing an exclusion of this sort that would be useful as a means for preventing the overbroad application of Section 457A.

C. Substantial Risk of Forfeiture

Background

A person's rights to compensation are treated as subject to a substantial risk of forfeiture only if the rights to compensation are conditioned upon the future performance of substantial services by any individual.[97] Section 457A defines "substantial risk of forfeiture" with substantially the same statutory language as used in Section 409A, but not by cross-reference.

The definition of substantial risk of forfeiture for purposes of Section 409A has been expanded under the Section 409A regulations to include entitlements conditioned on the occurrence of a condition related to the purpose of the compensation (i.e., a contingency based on a business goal of the service recipient).[98] The Notice clarifies that for purposes of Section 457A, "substantial risk of forfeiture" will *not* include such conditions even if the possibility of the risk of forfeiture is substantial.[99] Furthermore, the addition of any risk of forfeiture after the legally binding right to compensation arises, or any extension of a period during which compensation is subject to a risk of forfeiture is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture.[100]

1. Defining "Substantial" Services

Proposal

We recommend that the concept of "substantial" services be defined with reasonable flexibility, taking into account such considerations as the significance of services, without being limited to a mechanical test based on a minimum number of hours or period of service.

Discussion

Under Section 457A, the "rights of a person to compensation shall be treated as subject to a substantial risk of forfeiture only if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual."[101] Given the very restricted definition of substantial risk of forfeiture in Section 457A, it is important that

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[97] *See* Section 457A(d)(1)(A).

[98] *See* Treasury regulation Section 1.409A-1(d)(1).

[99] *See* Notice Q&A-3(a).

[100] *See* Notice Q&A-3(a). This rule also applies in the Section 409A context. *See* Treasury regulations Section 1.409A-1(d)(1).

[101] Section 457A(d)(1).

taxpayers be able to identify with some certainty the level or amount of services that will qualify as "substantial."

The Notice confirms that a substantial risk of forfeiture cannot be based upon the occurrence of a condition related to the purpose of the compensation. It also provides some additional detail that largely mirrors regulatory guidance under Section 409A, in providing that none of the following will constitute a substantial risk of forfeiture under Section 457A: a condition that the service provider refrain from performing services; a substantial risk of forfeiture that is added after the legally binding right to the compensation arises without a material increase in the present value of the compensation; or a forfeiture condition the enforcement of which is unlikely due to the service provider's ownership of a significant interest in the service recipient.[102] Neither Section 457A nor the Notice includes a definition of "substantial" services. However, there is some limited guidance under Sections 83 and 457(f).

Regulations issued under Section 83 provide that whether a requirement to provide future services constitutes a "substantial" risk of forfeiture is a question of facts and circumstances, and cite the regularity of the performance of services and the time required to provide them as indicative of "whether services required by a condition are substantial."[103] Examples in the Section 83 regulations indicate that two years, and possibly one year, can be "substantial."[104] Two year periods have also been found sufficient in various private letter rulings.[105] However, the Section 83 regulations appear to contemplate that a specification that a person be available to provide services upon request may suffice as a substantial risk of forfeiture, as long as he is in fact expected to perform the services, and that the services will be substantial.[106] Moreover, some case law under Section 83 illustrates that a condition not expressly requiring any particular period of services may nevertheless constitute a substantial risk of forfeiture if it is reasonably clear that the service provider must continue to perform services until the time of an event in order to retain property transferred.[107] Guidance under Section 457(f) has historically looked to Section 83 in interpreting "substantial services,"[108] and Section 409A does not include any specific discussion of the issue.

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102 Notice Q&A-3; *see also* Treasury regulations Sections 1.409A-1(d)(1) (refraining from performance or services and addition or extension of substantial risk of forfeiture) and 1.409A-1(d)(3) (enforcement of forfeiture condition).

103 Treasury regulations Section 1.83-3(c)(1) and (2).

104 Treasury regulations Section 1.83-3(c)(4), Examples 1, 3 and 4.

105 *See,* e.g., Priv. Ltr. Rul. 9642038 (Oct. 18, 1996) (compensation under unfunded plan of exempt organization determined to be subject to substantial risk of forfeiture for purposes of Section 457(f)); Priv. Ltr. Rul. 200009009 (Mar. 6, 2000) (to similar effect).

106 Treasury regulations Section 1.83-3(c) (2).

107 *Montelpre Systemed, Inc. v. Commr.,* 69 AFTR 2d 92-958 (5th Cir. 1992), *affirming* 61 T.C.M. 1782 (1991).

108 However, the Service and Treasury anticipate issuing guidance under Section 457(f) that will generally adopt the Section 409A rules relating to substantial risk of forfeiture. *See* Notice 2007-62, 2007-31 I.R.B. 331 (July 23, 2007).

While the uncertainty that there will be a sale at a profit is clearly not a substantial risk of forfeiture under Section 457A, significant services, although over a limited and possibly relatively brief period, may be required to effect the sale, and the possibility of forfeiture of those services are not provided should suffice to constitute a substantial risk of forfeiture where it is reasonably anticipated that significant services will be required. Stated differently, an undertaking to provide services over a short period of time some time in the future, or to make oneself available to do so, upon the occurrence of a future event and in connection with an identified task may well involve "substantial" services. In addition, the requirement that services be provided through to the occurrence of a particular event the timing of which is uncertain should be sufficient, in appropriate circumstances, to constitute a substantial risk of forfeiture.

For example, valuable and significant services may be performed over a short period of time where a particular task of significance, such as the sale of an identified property or the closing of a project, is contemplated and an individual or entity acting as a manager of the property or project may agree to provide services in connection with the ultimate disposition thereof, whenever that may occur, and to receive a percentage of any profits realized in connection with the sale so long as the person provides such services.

2. Specifying the Obligation to Provide Services

Proposal

We recommend that Treasury and the Service clarify whether the right to compensation must be expressly conditioned on the future performance of substantial services by a specified person in order to be considered subject to a substantial risk of forfeiture, or whether it will be sufficient if it is reasonably clear under the circumstances that the service provider will not be entitled to anything unless it performs the services.

Discussion

Neither Section 457A, the legislative history nor the Notice address whether the requirement that substantial future services be provided must be specifically spelled out in an arrangement subject to Section 457A (and, if so, the level of specificity required), or whether the obligation may be implied. For example, if a general partner of a partnership which is a nonqualified entity is entitled under the partnership agreement to a fee equal to a certain percentage of the net proceeds if certain partnership property is sold (net of debt and selling expenses) while the general partner continues to serve as such, the general partner is subject to termination if it fails to provide services, and it is reasonable to anticipate that the limited partner(s) will discharge the general partner if the general partner fails to continue to provide services through the date of sale, the right to payment should be viewed as subject to a substantial risk of forfeiture even if the agreement does not expressly provide that the right to payment will be forfeited if the general partner does not provide service through the date of sale.

3. Entity Service Providers

Background

The Notice states that the rights of a "person" to compensation must be conditioned upon the performance of substantial services by "such person."[109] Section 457A applies to service providers who are entities, as well as individuals.[110] Certain issues may arise where the service provider is an entity rather than an individual.

Proposal

We recommend that Treasury and the Service clarify that services required of an entity service provider need not be conditioned upon continued services of a particular individual associated with the entity, but may be provided by any of the entity's service providers.

Discussion

We understand that some in the market are concerned that Treasury and the Service may fail to respect an entity as a service provider. We believe that, where a bona fide entity has been retained to provide services, there is no reason to look to the individuals through which the entity provides services in applying Section 457A. For example, where an entity is providing ongoing services, and over the service period the individuals who actually provide the service on the entity's behalf change, such changes should have no effect for purposes of applying Section 457A.

4. Accelerated Vesting upon Death or Disability

Background

Section 409A contains various relief provisions for payments in the case of death or covered disabilities. Section 457A, which unlike Section 409A permits no deferral in those cases in which it is applicable (rather than providing rules for permissible deferral), can operate harshly in a case in which compensation may be deemed to have vested before payment, where the vesting event is death or disability. For example, a plan may provide generally that payment is deferred only as long as the employee continues to provide services, except that it may also permit deferral without any further service requirements, in the case of an in-service death or disability. Currently, under Section 457A the employee or the employee's estate would be required to include the deferred amount in income in the year that death or disability occurs.

Proposal

We recommend that Treasury and the Service provide an exemption from the substantial risk of forfeiture requirement with respect to compensation if the plan generally requires that further services be performed in order for the service provider to be entitled to receive future

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[109] Notice Q&A-3. But *cf.* Section 457A(d)(1)(A), which refers to services provided by "any individual" in defining substantial risk of forfeiture.

[110] Notice Q&A-5.

payments, except that such further services need not be performed in the case of death while in service or in the case of disability, as defined under Section 409A, while in service. If Treasury and the Service believe they do not have the authority to provide for such rule, we recommend a legislative change that would provide for such exemption, or give Treasury the regulatory authority to be flexible in these situations.

Discussion

Section 457A, if it applies, requires that compensation under a nonqualified deferred compensation plan be included in gross income once such compensation is no longer dependent on the future performance of substantial services. The statute does not explicitly address the situation where the service provider's right to compensation is accelerated due to death or disability, thereby eliminating the future service obligation but where the compensation remains deferred.

Since the likelihood of abuse in this scenario is extremely low, Treasury and the Service should provide relief where the right to compensation is not subject to the future services requirement solely because of the service provider's death or disability.

We acknowledge that Treasury and the Service may have limited authority to create such an exception in light of the statutory language that provides that rights to compensation are treated as being subject to substantial risk of forfeiture "*only*" if they are conditioned upon the future performance of services and requires income inclusion when there is no substantial risk of forfeiture. Consequently, if Treasury and the Service believe they do not have the authority to provide for such rule, we recommend a legislative change that would provide for such exemption, or give Treasury the regulatory authority to be flexible in these situations.

D. Short-Term Deferral Exception and ECI Exception

1. Short-Term Deferral Exception

Background

Compensation is not treated as deferred under Section 457A if the service provider receives payment of such compensation not later than 12 months after the end of the taxable year of the service recipient during which the right to the payment of such compensation is no longer subject to a substantial risk of forfeiture (hereinafter the "Section 457A short-term deferral").[111] The Notice clarifies that for purposes of the Section 457A short-term deferral rule the service recipient is the person for whom the service provider is directly providing services at the time the right to the payment of such compensation is first no longer subject to a substantial risk of forfeiture.[112] The Notice clarifies that the short-term deferral exception provided for in Treasury regulations Section 1.409-1(b)(4) (hereinafter "Section 409A short-term deferral") also applies for purposes of Section 457A, except that the more limited definition of "substantial risk of

[111] Section 457A(d)(3)(B).

[112] Notice Q&A-4.

forfeiture" of Section 457A is applied in lieu of the definition used for purposes of Section 409A.[113]

While the extension of the Section 409A short-term deferral rule to Section 457A is helpful, there are significant differences between these provisions. The Section 409A short-term deferral rule is more limited in application than the Section 457A short-term deferral rule. Under the Section 409A short-term deferral rule a deferred compensation plan will be exempt from Section 457A provided that (1) the service provider actually or constructively receives the payment of deferred compensation on or before the last day of the applicable 2 ½ month period in which the payment is no longer subject to a substantial risk of forfeiture and (2) the deferred compensation plan does not provide that the payment will be made upon a date or event which may occur outside the applicable 2 ½ month period.[114] The Section 457A short-term deferral rule merely requires that the service provider receive payment within 12 months after the end of the service recipient's taxable year during which the right to the payment is no longer subject to a substantial risk of forfeiture, but does not require that the deferred compensation plan require that such payment be made within the 12-months period. Also, under the Section 409A short-term deferral rule, the relevant 2 ½ month period is keyed off of the later of the end of either the service recipient's or the service provider's first taxable year in which the right to compensation is no longer subject to a substantial risk of forfeiture. The Section 457A short-term deferral rule is solely keyed off of the service recipient's taxable year.

We note that the Section 457A short-term deferral rule as currently drafted (i.e., in that its application does not depend on whether the plan requires that a payment be made within the relevant 12-month period as long as the payment is received during such period) is helpful in situations where taxpayers following the lapse of a substantial risk of forfeiture become aware that a nonqualified deferred compensation plan is subject to Section 457A (e.g., as a result of the proposed rule that the nonqualified entity status be tested on a yearly basis following the taxable year when it is no longer subject to substantial risk of forfeiture and remains deferred).

Example: A partnership enters into a deferred compensation plan with one of its U.S. employees on January 1, 2009. At the time the plan is entered into, the partnership is not a nonqualified entity. Assume that entitlement under the bonus plan is subject to a substantial risk of forfeiture. Assume also that the compensation would not be determinable at the time it would be required to be included in income under Section 457A. In 2015 an investor resident in Dubai acquires a 50 percent interest in the partnership as a result of which the entity becomes a nonqualified entity. If the U.S. employee receives payment within 12 months of the end of the partnership's taxable year during which the right to such payment is no longer subject to forfeiture (regardless of whether or not the plan requires such payment to be made within the 12-month rule), the compensation is not subject to Section 457A and thus also not subject to the 20 percent penalty tax.

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[113] Notice Q&A-4.

[114] The applicable 2 ½ month period is the period ending on the later of (1) the 15th day of the third month following the end of the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture or (2) the 15th day of the third month following the end of the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture. *See* Treasury regulation Section 1.409A-1(b)(4)(i)(A).

Proposal

We recommend that the rules for determining when a payment is received under Treasury regulations Section 1.409A-1(b)(4)(i)(B) should apply for purposes of the 12-month short-term deferral rule of Section 457A.

Discussion

Section 1.409A-1(b)(4)(i)(B) of the Treasury regulations sets forth rules as to when a payment is actually or constructively received for purposes of the Section 409A short-term deferral rule. In particular, payment is considered paid when an amount is includible in income under the economic benefit doctrine and the doctrine of constructive receipt itself. A simple change in the length of the short-term deferral period from Section 409A to Section 457A should not impact the applicability of the Section 409A concepts, and as such, they should apply fully to Section 457A short-term deferrals.

Proposal

We also recommend that the unforeseeable event exception rule in Treasury regulations Section 1.409A-1(b)(4)(ii) should apply for purposes of the Section 457A short-term deferral rule. The unforeseeable event exception could be applied to the effect that a taxpayer should not be subject to interest and penalties if due to unforeseeable events the compensation is not received within the relevant 12-month period but the plan originally required payment within the relevant 12-month period.

Discussion

Under certain circumstances a service provider may not know until 12 months or more following the close of its taxable year in which it would otherwise be required to include the deferred compensation in income whether or not a deferred compensation arrangement will qualify for the Section 457A short-term deferral rule.

Example: Assume a service provider with a calendar year taxable year enters on September 1, 2009 into a nonqualified deferred compensation plan with a nonqualified entity that provides for the payment of a bonus on June 30, 2011, provided that the service recipient achieves a certain profit level by June 30, 2011. The service recipient has a taxable year ending June 30. Under Section 457A the taxpayer would generally not be required to include the compensation in income in 2009 because of the application of the Section 457A short-term deferral rule. Assume that the service recipient does not pay the bonus until July 15, 2011, because of a liquidity shortage. In this example, the individual could be subject to interest and penalties for not including the compensation in income in 2009.

This result can occur as well even where there are no differences in the taxable years of the service provider and service recipient.

Example: Assume an underwriter (the service provider) enters into an arrangement on January 15, 2010 with a corporation (the service recipient) related to its IPO, providing that the underwriter will be paid a fee by December 31, 2011 assuming that the stock price of the

corporation has not decreased from its initial offering price by that time. Due to an unforeseeable event, the underwriter is not paid. Although the underwriter might have assumed the short-term deferral exception would apply, if the lack of payment prevents the exception from applying then the underwriter should have included the fee income in the 2010 taxable year.

The Section 409A short-term deferral rules provide certain exceptions under which a payment can be a short-term deferral even if it is delayed due to unforeseeable events. In general, a payment may be delayed if the taxpayer establishes that it was administratively impracticable to make the payment by the end of the applicable 2 ½ month period and at the time the legally binding right to the compensation arose, such impracticability was unforeseeable, or where the payment within the relevant period would jeopardize the ability of the service recipient to continue as a going concern.[115]

We believe that a similar unforeseeable event exception should apply for purposes of the Section 457A short-term deferral rule. Treasury and the Service may believe that such rule should only apply if the Section 457A short-term deferral rule is amended to provide that the plan must also require payment to be made within the 12-month period. Alternatively, the unforeseeable event exception could apply to exempt a service provider from the application of interest and penalties if he does not receive payment within the 12-month period but the plan had originally required payment within such period, provided that the failure to receive the payment was due to an unforeseeable event that was outside of the control of the service recipient.

2. ECI Exception under Section 457A

Background

Section 457A(d)(4) provides that compensation will not be subject to Section 457A in the case of a foreign corporation with income which is taxable as effectively connected income if, had such compensation been paid in cash on the date that such compensation ceased to be subject to a substantial risk of forfeiture, it would have been deductible by such foreign corporation against effectively connected income. The Notice clarifies that the principles of Section 882 and the regulations issued thereunder apply in determining deductibility against effectively connected income.[116] As a result of this exception, a nonqualified deferred compensation plan of a foreign corporation that would otherwise be a nonqualified entity (i.e., if such entity has less than substantially all of its income taxable as effectively connected income) may be exempt from Section 457A.

Proposal

- While we commend Treasury and the Service on the Notice's inclusion of Q&A-12, we recommend that Treasury and the Service expand the ECI exception so that it applies to any expense (regardless of whether deductible or capitalizable or nondeductible and

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115 Treasury regulation Section 1.409A-1(b)(4)(ii).

116 *See* Notice Q&A-12

noncapitalizable), as long as such expense is allocable to a trade or business conducted in the United States.

- In light of the current wording of the Notice, it would be helpful for Treasury and the Service to provide that the exception applies (i) even if a corporation has "negative" ECI (i.e., a loss) in the relevant taxable year in which the nonqualified deferred compensation would have been deductible by such entity and (ii) where the compensation expense rather than being deductible is capitalizable under the applicable rules into the basis of an asset, as long as the asset is effectively connected with the foreign corporation's U.S. trade or business.

- The Service needs to provide guidance how a nonqualified entity can establish the application of the exception. We also believe that as long as the foreign corporation had a reasonable good faith belief that the deduction is related to its effectively connected income, the compensation should be exempt from the application of Section 457A, even if the Service subsequently denies the deduction.

- Further, we recommend that Treasury and the Service provide for a comparable exception in case of partnerships. That is, if the nonqualified entity test is applied by reference to allocations of gross income there should be an exception for the nonqualified deferred compensation plan of a partnership, if the expense had the compensation been paid in cash on the date that such compensation ceased to be subject to a substantial risk of forfeiture, would have been allocable to a partner, whose distributive share of the partnership income is taxed as effectively connected income.[117]

Discussion

We believe that this exception is useful and certainly consistent with the principle that Section 457A is targeted at tax-indifferent service recipients. Where a foreign corporation's compensation expense is deductible against its ECI, such foreign corporation is clearly not indifferent to the deferred compensation.

From the language of the statute it is not clear whether the exception would also apply if the foreign corporation has no net ECI in the relevant taxable year (i.e., a loss). Treasury and the Service should clarify that the exception is also applicable in such year. Under certain circumstances, compensation expense may be capitalizable.[118] We believe that the exception should equally apply to such expenditures, as long as they are capitalizable into the basis of an asset (including start-up and similar expenses that are capitalized into goodwill), which is

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[117] This is consistent with our recommendations for an 80 percent gross compensation expense safe harbor, as set forth in Part IV.B.1. We believe that this proposal could operate in conjunction with such a safe harbor, but would be even more important if the Service does not adopt such a safe harbor.

[118] This would simply extend the rule in Q&A-12 of the Notice beyond the "goods" context ("If such compensation expense would have been part of the corporation's cost of goods sold, the compensation will be considered to have been deductible by the corporation against such income using any reasonable method that is satisfactory to the Secretary based on all facts and circumstances"). *But see* Treasury regulation Section 1.263-5(d)(2), which provides a simplifying convention that treats employee compensation as an expense, which does not facilitate a transaction and is thus generally deductible.

effectively connected with the foreign corporation's U.S. trade or business, or if the expenditure is a noncapital, nondeductible expense related to a U.S. trade or business. If these sorts of expense were not eligible for the ECI exception, then in practice an arbitrary amount of the compensation paid by the nonqualified entity engaged (or to be engaged) in business in the United States may be subject to Section 457A. We also note that since the determination is to be made in the year in which there is no longer a substantial risk of forfeiture (and presumably also after the 12-month short-term deferral period has ended), the allocation of compensation expense among deductible or capitalizable expenditures would in effect need to be done on a *pro forma* basis. We do not believe that this sort of exercise would be practical, nor even particularly relevant to determining whether the nonqualified entity is tax-indifferent.

Moreover, Treasury and the Service need to provide rules how a foreign corporation can establish the exception. We assume that it will be sufficient if the foreign corporation prepares and keeps in its files a pro forma calculation of its effectively connected taxable income for the year in which the compensation expense would have been deductible if it were paid in cash in such year that it is not longer subject to a substantial risk of forfeiture. Because a foreign corporation with ECI is subject to U.S. tax return filing requirements, it can be obligated to provide its service providers with a statement confirming the application of the exception. Such a statement can be part of the annual information statement, which we propose a corporation should issue to a service provider (see discussion in Part III.H.1). In order to avoid adverse consequences for service providers who relied on this exception, Section 457A should not be applicable if the Service subsequently denies the deduction as long as the corporation's treatment of the expense as allocable against its ECI was based on reasonable good faith belief.

The exception in the statute does not explicitly apply to partnerships. However, the Blue Book indicates that "it is intended that a foreign person that is a partner in a partnership not be considered a foreign person with respect to whom partnership income is not subject to a comprehensive foreign income tax to the extent that such person's share of partnership income is subject to U.S. income tax as income that is effectively connected with the conduct of a U.S. trade or business." We applaud the Notice for also adopting this view.[119] However, we believe that under the broad regulatory authority of Section 457A(e), Treasury and the Service could also exclude from Section 457A any deferred compensation that would be fully deductible against the ECI allocable to the various partners in the plan sponsor, even if only a portion of the foreign partners' shares in the partnership income is ECI. That is, there should be an exception for the nonqualified deferred compensation plan of a partnership, if the expense, had the compensation been paid in cash on the date that such compensation ceased to be subject to a substantial risk of forfeiture, would be deductible against the taxable amount of effectively connected income allocable to one or more partners. The proposal would be similar to an exception expressly provided in the statute for foreign corporations and thus should clearly be viewed as being consistent with congressional intent.

Example: A number of individuals resident in tax haven jurisdictions enter into a partnership that operates a trade or business in the United States and in Country X. They enter into a nonqualified deferred compensation plan with the head of their U.S. operations. Approximately half of the partnership's gross income is effectively connected to their U.S. trade

[119] Notice Q&A-11(e)(ii).

or business, and the other half is attributable to their Country X operations. Under the Notice, only the ECI is treated as allocable to an eligible person, and therefore the partnership fails the 80 percent test. However, all compensation paid to the individual who is entitled to the nonqualified deferred compensation is deductible against the partners' ECI, and therefore the partners are no more indifferent to the timing of the deduction than a U.S. resident would have been.

E. Service Provider and Independent Contractor Exception

Background

The Notice defines the term "service provider" similarly to the definition used for purposes of Section 409A.[120] The Notice also clarifies that Section 457A applies to cash-basis method and accrual method taxpayers. An independent contractor is not a service provider under Section 457A if an arrangement with respect to the independent contractor would be excluded from coverage under Treasury regulations Section 1.409A-1(f)(2).[121] Because Section 457A applies to fee income received by accrual-basis service providers (e.g., investment banks, consulting companies) that previously were able to ignore Section 409A, the independent contractor exception will become much more relevant.

1. Independent Contractor Exception

Proposal

We recommend that Treasury and the Service clarify that the determination as to when a service provider qualifies as an independent contractor for purposes of Section 457A is to be made at the same time as for purposes of Section 409A (i.e., at the time the service provider becomes legally entitled to the right to compensation) and does not need to be retested at the time the compensation is no longer subject to a substantial risk of forfeiture.

Discussion

The independent contractor exception provides that Section 409A generally does not apply to an amount deferred under an arrangement between a service provider and an unrelated service recipient if during the service provider's taxable year *in which the service provider obtains a legally binding right* to the deferred amount, the service provider (1) is actively engaged in the trade or business of providing services (other than as an employee or as a director of a corporation or similar position for other entities) and (2) provides significant services to two or more service recipients to which the service provider is not related and that are not related to one another.[122]

Under a safe harbor a service provider is deemed to be providing significant services to two or more such service recipients if the revenues generated from the services provided to any

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[120] Notice Q&A-5.

[121] Notice Q&A-5.

[122] Treasury regulation Section 1.409A-1(f)(2)(i).

service recipient or group of related service recipients during such taxable year do not exceed 70 percent of the total revenues generated by the service provider from the trade or business of providing such services.[123] For purposes of this threshold, an additional safe harbor provides that a service provider that has actually met the 70 percent threshold in the three immediately previous years is deemed to meet the 70 percent safe harbor for the current year (but only if at the time the amount is deferred the service provider does not know or have reason to anticipate that the service provider will fail to meet the threshold in the current year). The regulations also clarify that if at the time the legally binding right to the payment arose, the arrangement was not subject to Section 409A because of the independent contractor exception, the amount deferred and earnings credited thereto will not become subject to Section 409A in later years if the service provider becomes an employee or other service provider subject to Section 409A.

We recommend that the determination as to when a service provider qualifies as independent contractor for purposes of Section 457A is made at the same time as for purposes of Section 409A (i.e., at the time the service provider becomes legally entitled to the right to compensation) and does not need to be retested at the time the compensation is no longer subject to a substantial risk of forfeiture.

2. Management Services Exclusion

Proposal

We also recommend that Treasury and the Service clarify the scope of the management services exclusion of Treasury regulations Section 1.409A-1(f)(2)(iv). For example, Treasury and the Service should clarify that the provision of advisory services (e.g., consulting services or legal advice) that do not constitute investment management or investment advisory services to clients like hedge funds or real estate investment trusts should not disqualify service providers from the independent contractor exception. Further, Treasury and the Service should provide that an independent contractor such as a consulting firm that provides management advisory services to a client (e.g., how to improve reporting structures, synergy studies, etc.) is not intended to be covered by the management services exclusion.

Discussion

The independent contractor exception does not apply to a service provider to the extent the service provider provides management services to a service recipient. The reason behind this rule was to limit the ability of a service provider to retain the benefits of the deferral of compensation while having excessive control over the timing of the ultimate payment. For example, where the independent contractor is managing the service recipient, there is a significant potential that the service provider will have a say in structuring compensation arrangements.[124] "Management services" are defined as services that involve either (1) the actual or de facto direction or control of the financial or operational aspects of a trade or business of the service recipient, or (2) investment management or advisory services provided to a service

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[123] Treasury regulation Section 1.409A-1(f)(2)(iii).

[124] *See* Section I.C. of preamble to proposed Section 409A regulations, REG-158080-04, 70 Fed. Reg. 57930.

recipient whose primary trade or business includes the investment of financial assets such as a hedge fund or a REIT.[125]

Unfortunately there is little guidance regarding the scope of the term management services.[126] The definition of the term "management services" has two alternative prongs. The first includes services of any kind provided to any service recipient (regardless of the type of business in which it is engaged) provided that they involve the direction or control of the financial or operational aspects of the service recipient's trade or business (hereinafter the "general management services" prong). The second prong covers investment management and advisory services rendered to specific service recipients – that is, service recipients whose primary trade or business includes the investment of financial assets (hereinafter the "investment management services" prong).

Starting with the investment management services prong of the definition, it is unclear whether the adjective "investment" is meant to modify both "management services" and "advisory services", or whether the term "advisory services" includes advisory services of any kind (including advice that is not investment related). We believe that the term "advisory services" used in the investment management services prong of the definition is meant to include only "investment advisory services", rather than advisory services of any kind.[127] We recommend that Treasury and the Service clarify that the provision of advisory services that do not constitute investment management or investment advisory services (such as legal and accounting advice, consulting services, etc.) to clients like hedge funds or real estate investment trusts should not disqualify service providers from the independent contractor exception (assuming the services are not of a type that fall under the first prong, discussed below).

The first prong of the definition is also susceptible to a broad reading. In particular, it looks to whether the types of services provided – which appear not to be limited to investment-related advisory services – involve the control or direction of the financial and operational aspects of a service recipient's trade or business. The reference is to "a trade or business" of the service recipient, which suggests that the analysis applies separately to each trade or business.

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125 Treasury regulation Section 1.409A-1(f)(2)(iv).

126 The independent contractor exception was first introduced by Notice 2005-1, Q&A-8, 2005-2 I.R.B. 274. The Notice did not provide an exclusion for management services. The exclusion of independent contractors providing management services was first introduced in the proposed Section 409A regulations. *See* REG-158080-04, 70 Fed. Reg. 57930.

127 This is supported by the language used in the proposed Section 409A regulations, which introduced the exclusion. *See* REG-158080-04, 70 Fed. Reg. 57930. Under the wording of the proposed regulations the investment management services prong of the definition covered "*investment advisory services provided to a service recipient whose primary trade or business includes the management of financial assets (including investments in real estate) for its own account, such as a hedge fund or real estate investment trust*." In the final regulations, the language was expanded to include "*investment management and advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets (including investments in real estate), such as a hedge fund or real estate investment trust*." The preamble to the final Section 409A regulations does not provide an explanation for the change. It appears the drafters wanted to broaden the definition of the specific service recipients covered, by replacing the "management of financial assets for one's own account" with "investment of financial assets," but thought that the type of services covered needed to be expanded as well to include also investment management services.

Because of the separate existence of the investment management prong of the definition, we believe that investment management and investment advisory services as such are not covered under the first prong. The policy behind the management services exclusion expressed in the Preamble suggests that the provision was targeted at service providers that are independent contractors but that have a meaningful say in managing a line of business. This would suggest that an independent contractor such as a consulting firm that provides management advisory services to a client (e.g., how to improve reporting structures, synergy studies, etc.) was not intended to be covered by this provision. In its function as outside advisor on certain specific financial or operational aspects of a trade or business it is not exerting the type of influence on the management of such business (and thus indirectly on its compensation) that seems to have warranted the creation of the exclusion. We recommend that Treasury and the Service confirm that this interpretation is correct.

F. Service Recipients/Plan Sponsors

Background

Section 409A applies to nonqualified deferred compensation between a service provider and a service recipient. "Service recipient" is defined as the person for whom the services are performed and with respect to whom the legally binding right to compensation arises and all persons with whom such person would be considered a single employer under the controlled group aggregation rules of Section 414(b) and common control aggregation rules of Section 414(c).[128] Generally these rules treat entities as a single employer if they are under at least 80 percent common control through either a parent-subsidiary chain or ownership at a 50 percent level by five or fewer individuals, trusts or estates taking into account only ownership to the extent it is identical with respect to each organization. The definition of service recipient is relevant, among others, for purposes of determining whether SARs or stock options qualify for exemption from application of Section 409A (i.e., whether they are with respect to service recipient stock) and for purposes of applying the independent contractor exception.

Section 457A does not use the term service recipient (although this Report uses the term to provide clarity). Rather, Section 457A is focused on whether the nonqualified deferred compensation plan is of a "nonqualified entity." The Notice introduces the term "plan sponsor." A plan sponsor is any entity or entities which, if the entity paid the amount deferred in cash to the service provider in the relevant taxable year (which is generally 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) would be entitled to a compensation deduction under U.S. federal income tax principles.

Proposal

The Service should clarify that the terms "plan sponsor" and "service recipient" are not interchangeable.

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[128] Treasury regulation Section 1.409A-1(g).

Discussion

We assume that the definition of *service recipient* as defined for purposes of Section 409A rather than the definition of *plan sponsor* applies to determine whether SARs or nonstatutory stock options are with respect to service recipient stock (and thus potentially exempt from Section 457A); or whether a service provider meets the independent contractor exception. The term plan sponsor is determined with reference to the time that the deferred compensation arrangement is no longer subject to a substantial risk of forfeiture, while the determination of whether stock qualifies as service recipient stock or a service provider meets the independent contractor exception is determined at the time the service provider is legally entitled to the compensation. Also, as explained in detail in Part III.A below, we believe foreign law principles and disaggregation of affiliated entities should apply in determining the identity of the plan sponsor. For example, if a Dubai parent holds a French hybrid subsidiary that is treated as a disregarded entity for U.S. tax purposes but taxed as a corporation in France, the French entity should be treated as a plan sponsor with respect to compensation that is deductible from the entity's taxable income in France, even if the parent is treated as the service recipient.

G. Testing Date

Background

Section 457A does not provide when the "substantially all" income test or other aspects of the "nonqualified entity" status determination need to be made. The Notice provides that compliance with the "substantially all of the income" test is determined for the "taxable year of the foreign corporation ending with or within the service provider's relevant taxable year (as determined in accordance with Q&A-13).[129] According to Q&A-13(a), the relevant taxable year, is "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." If an entity "becomes a nonqualified entity" during a service provider's taxable year, amounts deferred under the plan are subject to Section 457A for the service provider's taxable year if the entity is a nonqualified entity as of the last day of the service provider's taxable year; amounts are not subject to Section 457A if an entity "ceases to be a nonqualified entity" during a service provider's taxable year and is not a nonqualified entity as of the last day of the service provider's taxable year.[130]

1. Single Date Determination

Proposal

We recommend that the entity status should be tested only at the time the service provider obtains a legally binding right to compensation. Avoidance concerns could be addressed through anti-avoidance provisions.

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[129] *See* Notice Q&A-8(a).

[130] *See* Notice Q&A-13(a).

Discussion

We believe that Treasury and the Service's approach of testing "nonqualified entity" status at the time the deferred compensation is no longer subject to a substantial risk of forfeiture is not consistent with the purpose of the provision and increases compliance burdens for service providers. The policy behind Section 457A is to prevent deferral of compensation where the respective deduction would be allocated to tax-indifferent parties. Very generally, if a service provider is subject to tax at the time it creates a nonqualified deferred compensation plan or provides an employee with rights under such plan, the tension between a service provider and the service recipient regarding the timing of the inclusion/deduction would exist at the time the service recipient makes its decision regarding whether it is willing to permit the service provider to defer.[131] Thus, the more appropriate time for such determination would therefore appear to be the taxable year in which the deferred compensation plan is entered into (i.e., at the time the service provider has a legally binding right to such compensation).

Moreover, as a result of Treasury and the Service's testing approach, a service provider will not know until the compensation is actually received whether or not the compensation is subject to Section 457A. This has the effect that the service provider takes the risk of adverse changes to the status of the service recipient (i.e., changes to income composition, qualification for treaty benefits, etc.) between the time the deferred compensation plan is entered into and the time the compensation is no longer deferred.

We recognize that an entity which is nonqualified in most years might, in theory, seize the opportunity to adopt a nonqualified deferred compensation plan in an unusual year, but this can be avoided by anti-abuse rules, which treat an entity as nonqualified if the service provider knew or should have known that the entity would be nonqualified in the year in which the nonqualified deferred compensation was no longer subject to a substantial risk of forfeiture (and the entity is in fact nonqualified in such year). Factors to be considered in applying such an anti-abuse rule might include, for example, whether the plan sponsor would be treated as nonqualified if the "substantially all" tests were applied over a three year period ending with the taxable year in which the plan was entered into, and whether the service provider was already providing services to the plan sponsor in years prior to the adoption of the nonqualified deferred compensation.

Another potential problem with a single date determination rule is that plan sponsors that are new or in a period of transition will often be entering into compensation plans before the source and composition of the entity's income reflects anticipated earnings. This is also an issue under a recurring testing approach. Again, this can be addressed by a rule that looks to whether the service provider knew or should have known that the plan sponsor would become nonqualified, but in this situation it would be more appropriate to consider factors such as whether the plan sponsor was nonqualified in the three year period following the year in which the plan was entered into, and whether the plan sponsor became nonqualified as a result of anticipated changes or fluctuations in the ordinary course of business (as opposed to changes that were unanticipated, such as unplanned restructuring, mergers, or acquisitions amongst the plan sponsor's affiliates, or changes in the identity of direct or indirect partners in a partnership).

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131 *See* Blue Book at 528 (discussing reasons for change).

If a single testing date is adopted, it may also be appropriate to allow plan sponsors that are new or are otherwise in a period of transition at the time a nonqualified deferred compensation plan was adopted to demonstrate to the satisfaction of the Secretary that at the time the plan was entered into, the plan sponsor reasonably believed that it would not be a nonqualified entity in the year in which the nonqualified deferred compensation was no longer subject to a substantial risk of forfeiture, and that the plan sponsor was in fact not a nonqualified entity in such year.

2. Recurring Testing and Changes to Plan Sponsor Status

Proposal

While we believe recurring testing is unnecessary for the reasons stated above, if the Notice's approach of requiring recurring testing is to be adopted in final regulations, we believe Treasury and the Service should promulgate rules which address how mergers, reorganizations and transactions resulting in the assumptions of liabilities under nonqualified deferred compensation plans affect the entity status determination. The Service should also provide for an exception that allows a service recipient to amend its nonqualified compensation plan (without violating Section 409A) upon the occurrence of any event that the plan sponsor reasonably believes will cause it to become a nonqualified entity, such as the sale of a subsidiary or business unit, a significant change in the identity of certain direct or indirect partners, or a relevant change in foreign tax laws.

Discussion

Based on Notice 2009-8, the nonqualified entity test must be reapplied every subsequent year in which the nonqualified deferred compensation is no longer subject to a substantial risk of forfeiture and remains deferred.

The Section 409A regulations contain rules that address, among other things, whether certain corporate transactions will result in the modification of stock rights or will disqualify the treatment of stock rights as issued with respect to service recipient stock. In the context of Section 457A, if Treasury and the Service retains the recurring testing approach promulgated in the Notice, rules are necessary that address how corporate transactions and reorganizations, including transactions that result in the assumption of liabilities under a deferred compensation plan, affect plan sponsor status.

For examples, consider the following:

Example 1: A foreign corporation that has a nonqualified deferred compensation plan in place, which since inception of the plan has never been a nonqualified entity, merges with an entity that is a nonqualified entity shortly before the payments under the plan are no longer subject to a substantial risk of forfeiture. It would appear inappropriate for Section 457A to apply to such plan where substantially all of the services had been provided during the life of the plan to an entity that was not a nonqualified entity. Similar results apply if the foreign corporation liquidates into a parent corporation that is a nonqualified entity, or if a division of a foreign corporation is spun off into a new corporation that is a nonqualified entity, or potentially even if substantial new subsidiaries are formed which generate excluded nonresidence income.

Example 2: A U.S. citizen is entitled to bonus payments under a deferred compensation plan of a Spanish company that would be subject to Section 457A if the entity were a nonqualified entity. Assume the Spanish corporation's assets and liabilities (including liabilities under the deferred bonus plan) are acquired by another Spanish corporation (either through merger or in an asset deal). The Spanish acquiring company is a nonqualified entity at the time of the U.S. employee's relevant taxable year (e.g., because its exempt income exceeds the 20 percent limit). The Spanish acquiring company would be the relevant plan sponsor for purposes of Section 457A, because it would be entitled to the deduction if it paid the bonus in cash at the time it is no longer subject to a substantial risk of forfeiture. It seems inappropriate that the bonus plan becomes subject to Section 457A merely because, at the end of the year in which the compensation becomes no longer subject to a substantial risk of forfeiture, the service provider has been acquired by a nonqualified entity, when the majority (or possibly all) of the services were provided to an entity that was not a nonqualified entity and at the time the plan was agreed to the service provider had no reason to expect that this takeover would occur.

Example 3: Same as Example 2 above, except under U.S. (and possibly Spanish) tax principles, the deferred compensation for the employee is *not* deductible by the Spanish acquirer, but rather is capitalizable. Which entity, if any, is the "plan sponsor"?

Example 4: A foreign entity with a nonqualified deferred compensation plan is treated as a disregarded entity for U.S. tax purposes. Under the Notice, its owner is treated as the plan sponsor. Suppose a second person becomes an owner before payments under the plan are no longer subject to a substantial risk of forfeiture. Now, assuming the proposal to disregard such changes described in Part III.A.2 is not adopted, the foreign entity is the plan sponsor, and the nonqualified entity determination is based on whether *its* income (rather than its parent's income) is substantially all subject to a comprehensive foreign income tax. Similarly, a (disregarded for U.S. tax) hybrid entity for which a "check the box" election is made could become a plan sponsor. The converse can apply where an entity treated as a partnership or corporation becomes treated as a disregarded entity.

If Treasury and the Service are not willing to provide an exception to Section 457A for situations such as these, in which the service provider is blindsided by unforeseen events, Treasury and the Service should at least provide for an exception to Section 409A that allows a service recipient to accelerate payments by amending its nonqualified deferred compensation plan upon the occurrence of any event that the plan sponsor reasonably believes will cause it to become a nonqualified entity. These events might include mergers and acquisitions, reorganizations, and significant acquisitions or dispositions of a subsidiary or business unit. In the case of a partnership, this should include a relevant change in the identity of direct or indirect partners to whom more than a certain percentage of the gross income is allocable. A relevant change in foreign tax laws or in Treasury and the Service's determination that a particular jurisdiction does not have a comprehensive income tax should also be sufficient reasons to accelerate payments.

Section 409A is designed to prevent service providers from having too much control over when they will receive payments under a nonqualified deferred compensation plan. Accordingly, any exception should not be so broad as to allow service providers to seize upon unrelated or insignificant events as an excuse for accelerating payments whenever desired. On

the other hand, it should not be contrary to the policy of Section 409A to allow income to be paid out in the circumstances described above. After all, distributions are allowed to be made under a plan upon certain changes in control,[132] and a plan may provide for the acceleration of a payment in an amount equal to the amount required to be included in income as a result of the plan's failure to comply with Section 409A.[133] Many changes, which do not qualify as changes in control under the current regulations, but would change a plan sponsor's nonqualified entity status, are similar to changes in control from a policy perspective. These changes would materially and adversely impact the service providers' position, and they would generally not be susceptible to manipulation by service providers attempting to accelerate their payments for non-tax reasons. Moreover, such an exception to Section 409A would not thwart the aims of Section 457A, as the compensation would in fact be includible in taxable income (because it would be constructively received).

The only reason we suggest that the standard be whether the service recipient *reasonably believes* that the change will trigger nonqualified entity status, rather than the stricter standard that the change in fact does trigger nonqualified entity status, is that both the legal and factual determinations required for evaluating nonqualified entity status are difficult and may not be possible until well after the taxable year has ended. Consequently, a service provider should not be hit with Section 409A's steep penalties simply because the service recipient errs on the side of concluding it is (or may be) a nonqualified entity and decides not to defer the payment. Section 457A aims to discourage deferral and accelerate when service providers pay taxes on their compensation, and it would be paradoxical if Section 409A penalties mandated deferral and discouraged current inclusion in borderline situations where Section 457A's applicability is unclear.

3. Clarification of Q&A-13

Proposal

If the Notice's approach of requiring recurring testing is to be adopted in final regulations, the rule expressed in Q&A-13(a) of the Notice should be clarified to state that the nonqualified entity determination for foreign corporations and partnerships is made as of the end of the taxable year of the entity *ending* with or within the service provider's relevant taxable year. The rule in its current form is somewhat ambiguous.

Discussion

Q&A-13(a) of the Notice specifies that the determination as to whether the deferred compensation is subject to Section 457A (and whether the entity is a nonqualified entity) needs to be 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. Q&A-13(a) states that compensation may be subject to Section 457A if the entity becomes a nonqualified entity in the relevant taxable year of the service provider and is a nonqualified entity on the last day of such taxable year. Assuming the taxable year of the entity is not the

[132] Treasury regulation Section 1.409A-3(i)(5).

[133] Treasury regulation Section 1.409A-3(j)(4)(vii).

same as the taxable year of the service provider, the taxable year of the entity will not have ended when the service provider's taxable year ends, and whether the entity would be a nonqualified entity based on the gross income in, and taxes owed for, such year is not yet determinable. The Notice does not provide that a taxpayer may rely on good faith estimates of the expected income of the entity for such current year.[134]

To put this in concrete terms, assume that (i) service provider X receives compensation, attributable to services performed after January 1, 2009, that is deferred under a nonqualified deferred compensation plan of entity B, (ii) X's taxable year begins on January 1, and (iii) B's taxable year begins on June 1. X's taxable years are denominated 2009, 2010, etc. B's taxable years are denominated Year 1, Year 2, etc. with Year 1 beginning June 1, 2008 and ending May 31, 2009. Under these facts, B's Year 1 *ends* within X's 2009 taxable year; and B's Year 2 *begins* within X's 2009 taxable year. The determination of whether B is a nonqualified entity at the end of X's 2009 taxable year may depend on whether the B year that is being tested is Year 1 or Year 2.

There are two specific rules in the Notice that state that one looks at Year 1 for this purpose. Q&A-13(b) provides that the nonqualified entity test for partnerships is determined based on the allocations of gross income by the partnership for the partnership's taxable year *ending* with or within the service provider's taxable year (that is, Year 1 of the partnership, ending May 31, 2009). Similarly, according to Q&A-8(a), the "substantially all" test is applied to a foreign corporation for the taxable year of the foreign corporation *ending* with or within the service provider's relevant taxable year (again, Year 1). As the examples below demonstrate, that is clearly the right answer.

However, Q&A-13(a) is worded more ambiguously. That is because, as stated above, Q&A-13(a) asks whether an entity "is" or "becomes" a nonqualified entity at the end of the service provider's taxable year. It is conceivable that that language could be read to mean that one must look to Year 2, on the theory that once it is determined at the end of Year 2 (May 31, 2010) that B is a nonqualified entity, that status applies retroactively throughout the entire Year 2, including the day that happens to be the end of X's taxable year (Dec. 31, 2009). Treasury and the Service should clarify that the general rule in Q&A-13(a) is to be applied in the same manner as the specific rules of Q&A-13(b) and Q&A-8(a), by reference to the taxable year of the entity ending with or within the service provider's taxable year.

The following examples demonstrate the point.

Example 1: B is a domestic partnership with four partners with equal shares in B's profits and losses. In Year 1, all of B's partners are U.S. citizens. In July 2009 (the second month of Year 2), one of these partners donates his interest in B to an entity exempt from tax pursuant to Section 501(a). Some of X's deferred compensation becomes no longer subject to a substantial risk of forfeiture in August 2009 (the third month of Year 2).

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[134] The Notice does allow reliance on a reasonable good faith estimate of the current year in the limited situation where the plan sponsor is a partnership that has not yet had a taxable year ending before or on the last day of the service provider's relevant taxable year.

X's deferred compensation is subject to Section 457A if B is a nonqualified entity as of Dec. 31, 2009, the last day of X's relevant taxable year. Under Q&A-13(b) of the Notice, whether B is a nonqualified entity as of that date is determined based on the allocations (or deemed allocations) of gross income by the partnership for Year 1 (ending May 31, 2009), because that is B's taxable year ending with or within X's relevant taxable year. Accordingly, Section 457A does not apply to X's 2009 taxable year. However, under the Notice, if X's compensation remains deferred and no longer subject to a substantial risk of forfeiture, Section 457A will apply for X's 2010 taxable year.

Example 2: B is a foreign corporation. Some of X's deferred compensation becomes no longer subject to a substantial risk of forfeiture in August 2009 (the third month of Year 2). B is not a nonqualified entity based on its gross income in and taxes owed for Year 1. B is a nonqualified entity based on its gross income in and taxes owed for Year 2.

The relevant taxable year of X ends on Dec. 31, 2009. Accordingly, the taxable year of B "ending with or within the service provider's taxable year" is Year 1. Assuming Year 1 is the correct determination year, then as in Example 1, Section 457A does not apply to X's 2009 taxable year. However, if the determination of whether B "is" a nonqualified entity at the end of the 2009 taxable year depends on B's status during Year 2, because Dec. 31, 2009 falls within Year 2, then Section 457A does apply to X's 2009 taxable year.

That is clearly the wrong answer, as a practical matter. X's normal tax return filing date is April 15, 2010, at which point B's status for Year 2 will not be known. X should not be compelled to extend the filing date for his tax return. More significantly, in this example X's compensation plan was negotiated when B was not a nonqualified entity, so there is no policy reason to determine whether X is subject to Section 457A by reference to Year 2 rather than Year 1. Q&A-13(b) and -8(a) already reflect this judgment; future guidance should make clear that that is also the general rule.

H. Determinability and Computation of Amounts

Background

If the amount under the deferred compensation plan to which the service provider is entitled is determinable at the time it is no longer subject to a substantial risk of forfeiture, it is taxable at such time. If it is not determinable at that time, it is includable in income once it is determinable, subject to an additional penalty tax equal to 20 percent of the amount of the compensation and imputed interest.[135] The statute contains no definition of the term "determinable." The Blue Book, for example, indicates that an amount is not determinable if the amount varies depending on the satisfaction of an objective condition.[136] The Notice clarifies

[135] Section 457A(c)(1). *See also* Notice Q&A-21.

[136] The Blue Book provides the example of a deferred amount that varies depending on the satisfaction of an objective condition at the time the amount is no longer subject to a substantial risk of forfeiture (e.g., no amount is paid unless a certain threshold is achieved, 100 percent is paid if the threshold is achieved and 200 percent is paid if a higher threshold is achieved). The Notice contains the example of an annual bonus based on annual profits as of December 31, 2010 and provides that at all times prior to December 31, 2010, the amount is not determinable. *See* Notice Q&A-19.

that an amount will be treated as not determinable when the deferred amount would be calculated under proposed Treasury regulations Section 1.409A-4(b)(2)(iv) – which is the rule that applies to compensation based on formula amounts.[137] Treasury regulations Section 1.409A-4(b)(2)(iv) does not apply to account balance plans,[138] which presumably should always be considered determinable.

1. Clarify Scope of "Determinability"

Proposal

In light of the harsh consequences of an amount being considered not "determinable" for Section 457A purposes, we propose that Treasury and the Service provide guidance to what extent certain commonly used deferred arrangements would be considered "determinable."

Discussion

The Notice does not clearly state that an amount other than an amount based on formula amounts will not be considered determinable for purposes of Section 457A. To the extent that the definition given in the Notice is not inclusive, it would be helpful if guidance could clarify the treatment of the following commonly used deferral arrangements:

- The Service should clarify that compensation related to RSUs, SARs and nonqualifying options is "determinable" in an amount based on the value of the stock or the spread at the end of the relevant year.
- Compensation made in a non-functional currency should be considered "determinable" based on foreign exchange rates at the end of the relevant year. Alternatively, Treasury and the Service should provide that the non-functional currency nature of compensation does not itself make the amounts non-determinable.
- The Service should clarify that compensation amounts that are difficult to determine (e.g., compensation tied to the annual increase in value of a real property or artwork) are nonetheless determinable, to the extent that they do

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137 Notice Q&A-19. Under this rule, an amount payable for determining the total amount deferred for the taxable year must be determined on the facts and circumstances as they existed as of the close of the last day of the taxable year (and using reasonable, good faith assumptions). If facts and circumstances change in a subsequent year resulting in a change to the amount payable, such change shall be treated as earnings or losses.

138 An account balance plan is a nonqualified deferred compensation plan under the terms of which a principal amount (or amounts) is credited to an individual account for an employee, the income attributable to each principal amount is credited (or debited) to the individual account, and the benefits payable to the employee are based solely on the balance credited to the individual account. *See* Treasury regulations Section 31.3121(v)(2)-1(c)(1)(ii)(A).

not constitute formula amounts.[139] (By contrast, compensation tied to multi-year returns from assets generally would *not* be determinable).

2. Plans with Both Determinable and Nondeterminable Amounts

Proposal

The Service should clarify that the 20 percent additional tax only applies to the "nondeterminable" component of a nonqualified deferred compensation plan, where such compensation also has a "determinable" component (i.e., permit the taxpayer to segregate the compensation, where possible). Alternatively, Treasury and the Service should provide for a *de minimis* rule pursuant to which a small amount of nondeterminability does not trigger the 20 percent additional tax.

Discussion

The punitive treatment of nondeterminable amounts appears to be related to Congress's aim of dissuading service providers from entering into nonqualified deferred compensation plans under which accelerated income inclusion is not possible. Since most of Section 457A is designed to accelerate income inclusion, it makes little sense to prevent service providers who can calculate a portion of their nonqualified deferred compensation amount from including at least that amount on a current basis.[140] In fact, if disaggregation is not adopted as the appropriate rule, service providers who believe the likelihood they will receive their deferred compensation is remote for reasons unrelated to the performance of services may choose to gamble with the 20 percent additional tax, rather than include the determinable amount currently and have to worry about whether they will be able to use a deduction or loss in the future. Even if the 20 percent additional tax is imposed, if the value of the compensation actually paid is significantly less than the prior present value of the determinable amount, the tax imposed may be less (assuming the deduction or loss for the prior over-inclusion would not have been available at the time the compensation is actually received).

Example: A service provider is entitled to receive nonqualified deferred compensation in Year 4 equal to $x or, if greater, a percentage of the aggregate profits for Years 1, 2, and 3 (but not any interest on such amounts). Assume the right to compensation is no longer subject to a substantial risk of forfeiture beginning in Year 1, and that the plan sponsor and service provider have the same taxable year. In Year 1, the service provider should include in income the greater of the present value of $x or the present value of the percentage of annual profits for Year 1. In Year 2, the service provider should include in income the excess of the present value of the percentage of aggregate profits for Years 1 and 2 over the present value of the income already included in Year 1, and pay premium interest and the 20 percent additional tax on such excess.

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[139] We note that in many cases, such difficult assessments will be required in any event for financial accounting purposes.

[140] *See also* Proposed Treasury regulations Section 1.409A-4(b)(2)(vi) which adopts a bifurcation approach by providing that if a portion of a deferred amount is determinable under other rules of the regulations, such other rules apply to such amounts and only the balance of the amount is determined under the rules applicable to formula amounts.

Similarly, in Year 3, the service provider should include in income the excess of the present value of the percentage of aggregate profits for Years 1, 2, and 3 over the present value of the income already included in Years 1 and 2, and pay two years' worth of premium interest and the 20 percent additional tax on such excess. In Year 4, the service provider should make adjustments to the extent the amount received does not equal the present value of the amount already included in income, but should not be subject to any further premium interest or 20 percent additional tax.

If Treasury and the Service believe such disaggregation is not possible under the statute, they should adopt a *de minimis* rule to prevent a small amount of nondeterminability from triggering deferral and the 20 percent additional tax.

3. Election to Include Amounts Otherwise Not Determinable

Proposal

The Service should permit a taxpayer to make an election under which nondeterminable compensation can be recognized up-front at the time it is no longer subject to a substantial risk of forfeiture, provided that the amount recognized is not less than the amount actually received, or that only any amount received in excess of what was actually received is subject to the 20 percent additional tax.

Discussion

Despite the importance of the term "determinability" in the statute, there is currently little guidance illustrating the scope of the term. Interestingly, the Notice refers to the rules under Proposed Treasury regulations Section 1.409A-4(b)(2)(iv). However, while these rules apply to amounts that are considered also not determinable for Section 409A purposes, Section 409A nevertheless requires the service providers to determine the amounts based on reasonable, good faith assumptions. Thus, for Section 409A purposes all amounts must be valued even if they are hard to value. The Section 409A rules provide for adjustments if the amounts included in income based on the application of these determinability rules differ from the actual amounts received.

It seems incongruous that under Section 409A "nondeterminable" amounts are actually considered somehow "determinable" and required to be included currently, while for Section 457A purposes they remain nondeterminable and may not be included currently. In light of this inconsistency and because of the drastic cliff effect of whether or not an amount is determinable for Section 457A purposes, we would recommend that Treasury and the Service permit taxpayers to make an election to include nondeterminable compensation in income at the time it is no longer subject to a substantial risk of forfeiture based on reasonable and good faith assumptions, provided that the 20 percent additional tax and interest charge will apply to the excess, if any, of the amount actually received over the amount already included in income. Assumptions should be considered reasonable and in good faith if they would be so considered for purposes of Section 409A, so that assumptions which are explicitly impermissible under Section 409A will also be impermissible under Section 457A.

We envisage that this election could work as follows: Assume facts similar to the example provided in the legislative history of an "nondeterminable" deferred compensation plan: no amount will be received by the service provider unless the service recipient's profits in a future year exceed a certain threshold, 100x will be paid if the threshold is achieved, and 200x will be paid if a higher threshold is achieved. If reasonable projections estimate that there is a 75 percent likelihood the base threshold will be achieved and a 25 percent likelihood that the higher threshold will be achieved, a taxpayer should be permitted to make an election to include either the present value of 100x in income at the time it is no longer subject to a substantial risk of forfeiture, or the present value of 200x. Even though it may be more likely than not that the higher threshold will not be reached, the taxpayer should be able to decide which election to make based solely on the extent to which he is willing to take that risk. The Service will be in the same or better position if the taxpayer overestimates the amount, and it would seem unjust for the Service to argue that 200x was an unreasonable overestimate based on facts available at the time in the event the 200x amount is actually received. This also serves the general statutory purpose of avoiding income deferrals.

4. Loss Following Prior Income Inclusion.

Proposal

If an amount is required to be included in income under Section 457A before the amount is actually paid to the service provider and such amount is subsequently forfeited, we recommend that Treasury and the Service provide that taxpayers can reduce their adjusted gross income by the full amount of loss, even if they elect not to itemize deductions or are subject to the alternative minimum tax.

Discussion

Notice Q&A-18 provides that a service provider is entitled to claim a loss (in accordance with proposed Treasury regulations Section 1.409A-4(g)) if an amount is required to be included in income under Section 457A before the amount is actually paid to the service provider and such amount is subsequently forfeited. Such deduction would be subject to the 2 percent floor for itemized deductions and would not be deductible for purposes of the alternative minimum tax.[141] We recommend that Treasury and the Service provide that taxpayers can reduce their adjusted gross income by the full amount of loss regardless of whether they elect to itemize

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[141] *See* Preamble to Proposed Treasury regulations Section 1.409A-4, Fed. Reg. Vol. 73, No. 236 p. 74380:

"For example, if at the end of Year 1 an employee has an account balance of $100,000 which is required to be included in income under Section 409A, and at the end of Year 2 an employee has an account balance of $90,000 due to notional investment losses, the employee would not be entitled to a deduction for Year 2. However, if in Year 3 the entire account balance of $95,000 is paid to the employee, so there no longer are any amounts deferred under the plan (determined after applying applicable aggregation rules) and nothing remains to be paid to the employee, the employee would be entitled to a $5,000 deduction for Year 3. In the case of a service provider that is an employee, the available deduction generally would be treated as a miscellaneous itemized deduction, subject to the deduction limitations applicable to such expenses. Section 1341 would not be applicable to such deduction because inclusion of an amount in income as a result of noncompliance with Section 409A(a) would not constitute receipt of an amount to which it appeared that the taxpayer had an unrestricted right in the taxable year of inclusion."

deductions, and for purposes of the alternative minimum tax as well as the ordinary tax. We do not believe there is any policy justification, or statutory mandate, for requiring taxpayers to accelerate the inclusion of income that they have not economically received (and may not even be likely to receive), and then denying them a full deduction when and if it becomes apparent that they will not in fact receive the income.

5. Recapture of Deduction

Section 457A applies to nonqualified entities that are required to compute taxable income or earnings based on U.S. tax rules (e.g., CFCs, PFICs, partnerships with U.S. partners) and are sponsors of nonqualified deferred compensation plans, regardless of whether the service provider is a U.S. person or not. Application of Section 457A may accelerate the deduction for these entities even if there is no corresponding income inclusion (for U.S. tax purposes) for the service provider.

Proposal and Discussion

We believe that the result of a deduction for the plan sponsor prior to the inclusion of income by the service provider is consistent with other differences in accounting between U.S. service recipients and non-U.S. service providers under Section 457A and is therefore appropriate. In some circumstances, however, this may allow for a deduction prior to the time the all-events test is met and the obligation is accrued (in the common sense understanding of that term).[142] Given this result, it is possible that compensation arrangements may be structured with the purpose, or at least the effect, of generating what might be viewed as an unwarranted tax benefit for the plan sponsor. In addition, if Section 457A is to apply on the *deduction* side without regard for whether the service provider is a U.S. taxpayer, it presumably would require U.S. taxpayers, in some circumstances, to determine the applicability of Section 457A to controlled foreign corporations in which they are (or become) ten percent U.S. shareholders, to passive foreign investment companies in which they are or become shareholders, and to partnerships in which they are partners, even in circumstances in which Section 457A is not directly relevant to either the plan sponsor or the service provider. Neither of these results is desirable. Given this, we believe that it also would also be appropriate for Treasury and the Service to provide that no deduction is allowable until the all-events test is met.[143]

In the event that the plan sponsor does recognize a deductible expense in the year of income inclusion for the service provider, we believe that it would be proper for Treasury and the Service to require a recapture of that deduction in the event such compensation is ultimately forfeited and not paid (e.g., because a non-service related requirement was not met).[144]

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[142] Forfeiture after the inclusion of compensatory income is potentially more likely to occur in the Section 457A context due to the fact that substantial risk of forfeiture relates solely to the performance of services, so non-service contingencies would be disregarded even if they were quite likely to occur.

[143] Most plan sponsors will be accrual method taxpayers. In the event that a plan sponsor is a cash method taxpayer, the deduction could be deferred until a cash payment has been made.

[144] *Cf*. Treasury regulations Section 1.83-6(c).

If such a rule is implemented, in circumstances in which the service recipient is a partnership and has allocated the compensation expense related to the Section 457A inclusion among its partners, we suggest that the recapture amount should, to the extent possible, be allocated to those partners that received the prior benefit of the deduction. This might be implemented by treating the recapture amount as a built-in gain item under Section 704(c).[145] Such a rule would help prevent situations in which the benefit of an accelerated deduction is enjoyed by one partner (e.g., a U.S. taxpayer) and the income inclusion reversing the deduction is borne by another partner (e.g., a tax-exempt or foreign partner).

III. International Tax Issues

A. The Identity of the Plan Sponsor

As mentioned above Section 457A does not use the term service recipient to describe the employer or payor of the nonqualified deferred compensation. Rather, the Notice introduces the term "plan sponsor." The entity that is considered the "plan sponsor" under the Notice is the entity that needs to be tested as to whether it constitutes a nonqualified entity for purposes of Section 457A.[146] The introduction of the concept plan sponsor raises various issues. This part describes the issues resulting from the interplay of the definition "plan sponsor" and the nonqualified entity determination.

1. Relevance of Foreign Tax Principles

Proposal

We recommend that the term "plan sponsor" be defined as the entity that would be entitled to a deduction for the nonqualified deferred compensation by looking to foreign law principles rather than U.S. tax principles. If Treasury and Service officials believe that the statutory language of Section 457A does not permit the determination of whether an entity is a nonqualified entity by reference to foreign (rather than U.S.) rules, then we recommend that Section 457A be amended to allow for the application of foreign law in determining the identity of the plan sponsor.

Discussion

Even though it creates a degree of complexity as a compliance matter (discussed further below), the Notice's treatment of partnership plan sponsors quite sensibly looks to see whether someone, somewhere, is paying taxes, on a current basis, on the income of the plan sponsor. This is implemented by allowing an entity that is a partnership for U.S. tax purposes and that is a plan sponsor to "allocate" income to itself for purposes of determining whether income is

145 This would be similar to (if the converse of) the rules for built-in contingent liabilities under Treasury regulations Section 1.752-7.

146 The term "service recipient" as used in Section 409A, however, remains relevant for purposes of Section 457A due to the extension of the application of various Section 409A rules to Section 457A (which use the term service recipient rather than plan sponsor). Part II.F describes the uncertainties created as a result of the application of both terms – plan sponsor and service recipient – under Section 457A.

allocated to an eligible person, provided that the partnership is subject to a comprehensive foreign income tax with respect to such income.

Similarly, the determination of the plan sponsor ought to consider whether compensation paid to the employee is deductible on a current basis by someone, somewhere, whose tax liability for a given year might increase if the compensation were not paid in that year. The Notice recognizes the relevance of compensation deductions, but fails to recognize the relevance of foreign tax principles, in its definition of "plan sponsor."

In Notice Q&A-14, the plan sponsor is "any entity or entities which, if the entity paid the amount deferred in cash to the service provider in the relevant taxable year … would be entitled to a compensation deduction under U.S. federal income tax principles." The problem with this definition is that Congress was trying to identify as nonqualified entities those service recipients who are indifferent to the timing of compensation payments. A foreign corporation that pays comprehensive foreign income taxes and is entitled under the law of its tax jurisdiction to a compensation deduction is presumably not indifferent to the existence or timing of the compensation deduction, just like any domestic corporation that is subject to tax. On the other hand, a foreign corporation that pays comprehensive foreign income taxes but would never receive a deduction against those foreign taxes for compensation payments made by its subsidiaries or branches is probably indifferent to the timing of such compensation payments, and simply should not be treated as the plan sponsor. Under the current rule, the foreign corporation in the former scenario may not be treated as plan sponsor if it is not entitled to a deduction applying U.S. tax principles, while the foreign corporation in the latter scenario may be treated as the plan sponsor, irrespective of the fact that under foreign law it is not entitled to a deduction for compensation of its disregarded subsidiaries or branches. We believe that the entity that should be tested is the entity that would actually benefit from the compensation deduction, not the one that would hypothetically receive the benefit under U.S. principles.

This general principle can also be applied to controlled group aggregation issues (discussed in greater detail under Part III.I below). If a foreign country allows related entities to file a consolidated return, and compensation payments made by one of the entities is deductible against the collective income of the entire group, the consolidated group as a whole should be treated as the plan sponsor, and evaluated on an aggregate basis. If the foreign country does not allow the controlled group to file a consolidated return, or the controlled group simply elects not to file a consolidated return, the plan sponsor generally should be judged on a stand alone basis, even if such entity checks the box to be treated as disregarded for U.S. tax purposes (although we believe that an elective aggregation rule may in certain circumstances be appropriate. See Part III.I below).

Treasury and the Service may prefer that the determination be made by reference to U.S. tax principles for the reason that U.S. taxpayers are familiar with U.S. rules. However, several aspects of Section 457A (i.e., the nonqualified entity determination) already require taxpayers to familiarize themselves with the laws of the tax jurisdiction of the foreign entity. Looking to foreign tax principles in determining "plan sponsor" status of an entity does not add more complexity to an already complex determination, and may avoid certain nonsensical results (e.g., where a parent corporation is regarded as the plan sponsor even though its disregarded subsidiary

is the employer under local law, and then income of the disregarded subsidiary may be treated as "excluded" under U.S. principles because the foreign jurisdictions do not treat it as disregarded).

Another possible reason why Treasury and the Service chose to apply U.S. principles to the definition of "plan sponsor" may have also been because of the concern that some plans would not have any sponsors if only applicable foreign principles were applied. However, the solution to this concern is simple. If a service provider that receives nonqualified deferred compensation is unable to identify any entity anywhere in the world that would actually be entitled to a deduction for compensation payments to the service provider under some comprehensive foreign income tax regime, then such plan is by definition a nonqualified plan of a nonqualified entity, subject to Section 457A. The precise identity of the plan sponsor would no longer be relevant to the threshold question of whether Section 457A is applicable.

2. Hybrid Entities and Branches

Proposal

If as a result of applying foreign tax principles as discussed above, the entity identified as the plan sponsor is a disregarded entity for U.S. tax purposes (but a corporation for foreign law purposes) (i.e., a hybrid entity) or a "true" branch for U.S. tax purposes[147], such entity or branch should nevertheless be treated as the plan sponsor for purposes of Section 457A. Where the entity identified is a wholly-owned pass-through for foreign tax purposes, other than a true branch, the plan sponsor should be the owner of such entity.

Discussion

The statutory language of Section 457A presupposes that all plan sponsors are either corporations or partnerships. This raises the question of how hybrid entities (i.e., entities that are disregarded for U.S. tax purposes and are corporations for foreign law purposes) or "true" branches ought to be classified. The Notice defines a "foreign corporation" as a corporation under Section 7701(a)(3) that is not domestic under Section 7701(a)(4), and defines a "partnership" by reference to Section 7701(a)(2). Under this formulation, foreign entities that are disregarded for U.S. tax purposes or are true branches are treated as part of the parent entity.

We recommend that, contrary to the position taken in the Notice, guidance should provide that in the case of hybrid entities the classification of an entity for foreign tax purposes should control when applying Section 457A, as Section 457A is primarily concerned with the extent to which an entity's income is subject to foreign income taxes. Thus, in the case of the determination of plan sponsor status, the hybrid entity should be considered a plan sponsor if it is entitled to a compensation deduction under foreign law, irrespective of the fact that it is a disregarded entity for U.S. tax purposes. We believe that this recommendation could be implemented whether or not the recommendation above (regarding the use of foreign law principles regarding deductions) is implemented.

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[147] By "true" branch we mean the conduct of a trade or business in unincorporated form, but where the operations maintain separate books and records.

Example: Assume a U.K. corporation with multiple U.K. and non-U.K. operating subsidiaries that are treated as disregarded entities for U.S. tax purposes. Assume these subsidiaries have deferred compensation plans in place pursuant to which U.S. employees are entitled to compensation. If the determination of plan sponsor status is made with reference to only U.S. tax principles, the U.K. parent corporation would be the relevant plan sponsor (it would be entitled to a compensation deduction under U.S. law since its subsidiaries are all disregarded). However, it may be more appropriate to look at a specific operating subsidiary as the relevant plan sponsor if it is entitled to a deduction under foreign law and apply the nonqualified entity test at that level. Assume in the above example that one of the subsidiaries is a French company that is subject to tax in France. It is entitled to a compensation deduction with respect to the deferred compensation under French law. It appears incorrect as a conceptual matter that the test is applied at the U.K. parent level for U.S. tax purposes (and hinges on the U.K. parent's income composition and eligibility for LOB provisions, etc.), where there is a different entity entitled to the deduction under foreign law that has an interest at stake. Under our recommendations, each of these subsidiaries would be treated as the plan sponsor for purposes of applying Section 457A.

Treating a hybrid entity as a separate taxpayer should not raise significant compliance concerns. Because the entity is a recognized separate taxpayer under foreign law, it will generally be required to account for its income on a separate basis or at least maintain its books and records on a separate basis. This should enable a taxpayer to determine whether the entity would be entitled to a deduction under foreign law and whether the entity constitutes a nonqualified entity.

The treatment of "true" branches for U.S. tax purposes creates similar issues as the treatment of hybrid entities. Currently, it is not clear how to apply Section 457A to a foreign parent corporation that has branches in foreign countries, the income of which is subject to tax in such foreign countries and where such branches are the "employers" of the service providers subject to Section 457A.[148]

Example: A large international financial institution owns an Irish, Dubai and Russian branch through its German subsidiary that is treated as a foreign corporation. The income of the Irish and Russian branch is exempt from German tax due to the application of a tax treaty, while the income of the Dubai branch is subject to current German taxation. Assume each of these branches is the employer under local law of several U.S. citizens that are entitled to nonqualified deferred compensation. Under the existing rules, the German parent would be treated as the plan sponsor for all of these employees. Whether or not Section 457A would apply to the deferred compensation would depend on the nonqualified entity status of the German parent. The German parent may constitute a nonqualified entity if the nonresidence source income earned through its Irish and Russian branches constitutes more than 20 percent of its gross income. Thus, the application of Section 457A would depend on the relative sizes of the various branches and could change over time. This would yield an unreasonable and totally arbitrary result,

[148] Indeed, most countries with which the U.S. has entered into double tax treaties exclude active nonresidence source income from the domestic taxable base of corporations that are resident in such countries. Examples include Germany, France, Switzerland, Canada, Belgium, and the Netherlands.

especially where the branches (e.g., Ireland and Russia) are subject to comprehensive foreign income taxes and bear the cost of the compensation.

Under our recommendation, a similar rule could be applied to true branches (i.e., permanent establishments) and the plan sponsor status would be determined by reference to foreign law. The nonqualified entity determination could be applied at the branch level where the branch is the sponsor of the plan (i.e., bears the cost of the compensation), and is subject to tax in the jurisdiction of the branch, by treating the branch as if it were a separate corporation. Assuming that under foreign law the operations of the branch are treated as being conducted by the "parent" foreign entity, we believe it would be appropriate to *also* treat the foreign entity as a plan sponsor, and to treat Section 457A as not applicable if *either* the branch (on a stand-alone basis) or the foreign entity is not a nonqualified entity. We note that treating a branch as a plan sponsor, at the same time as the owner of the branch is treated as a plan sponsor, is consistent with the statutory rule under which compensation attributable to a United States branch of a foreign entity may be exempted from Section 457A (whether or not the foreign entity is a nonqualified entity), and we believe that it is desirable to treat U.S. branches and non-U.S. branches in a parallel fashion.

Although on the margins it might be slightly more complicated to determine the gross income attributable to the branch and determine the extent to which it is subject to a comprehensive foreign income tax, we do not believe that compliance should be much more difficult. Many such branches are regulated (i.e., branches of financial institutions), or are taxed as permanent establishments, and as a result are already generally required to account for their income on a separate basis or at least maintain their books and records on a separate basis. This should enable a taxpayer to determine whether the branch would be entitled to a deduction under foreign law and whether the branch constitutes a nonqualified entity (if it were a corporation). (If Treasury and the Service feel that administrability would otherwise be compromised, this proposal extending "plan sponsor" status to true branches could be limited to branches that are regulated, audited, or are reflected in local law tax returns.)

If the foregoing recommendation is adopted with the result that true branches or hybrid entities may be plan sponsors, the application of the treaty test or tax system test for purposes of determining their nonqualified status would need to be slightly amended. The Notice requires (as discussed below) that the plan sponsor, which is being tested for its nonqualified entity status, either (under the tax treaty test) be a resident of a treaty jurisdiction and qualify for limitation on benefits provisions or, alternatively (under the tax system test) be a resident of a jurisdiction that has a comprehensive foreign income tax. A true branch may never itself be treated as a resident of a jurisdiction. Consequently, in applying the foregoing tests to a branch, its "residence" should not be relevant. This is consistent with the statutory requirements.[149]

We believe that the above described proposal represents a sensible solution that avoids arbitrary results, which clearly where not intended by the statute. We are concerned that if the determination is not made by reference to foreign law, compensation expense that is borne by an

[149] The Notice requires that, in order to meet the tax system test, the foreign corporation must demonstrate that it is a "resident" for tax purposes in a jurisdiction with a comprehensive income tax. The statute, by contrast, only requires a showing that the corporation is "subject to" a comprehensive income tax.

entity that is subject to comprehensive foreign income tax may be caught by Section 457A, merely as a result of the income composition of an affiliate of such employer, only because U.S. law principles treat such affiliate as the actual plan sponsor. Appendix A to this Report contains illustrative examples that highlight the different outcomes of a nonqualified entity determination, depending on whether one follows the rule enunciated in the Notice (which can lead to arbitrary results depending on U.S. tax characterization of entities) or the proposal described above.

Although we acknowledge that the position taken in the Notice (that "corporations" and "partnerships" are to be determined under U.S. tax principles rather than foreign principles) may be the most literal reading of the statute in the absence of further guidance, Treasury has fairly broad power under the statute to prescribe regulations that yield more sensible and appropriate results. We believe that this interpretation is not foreclosed by the statutory language of Section 457A. While the Code does have definitions of "corporations" and "partnerships" for U.S. tax purposes,[150] the statutory language of Section 457A does not cross-reference these Code definitions, and the use of U.S. principles is not effectively required by the purposes of the statute (to the contrary, use of U.S. principles can lead to arbitrary results).[151] In these circumstances we believe Treasury does have authority to define the term "plan sponsor" (or, looking at the statutory definitions, to define when there is a "plan of a nonqualified entity") by reference to foreign law concepts of entities. This may be viewed as an exercise of regulatory authority to determine whether "substantially all" of an entity's income is subject to a comprehensive foreign income tax. In other words, if a foreign corporation owns a hybrid entity treated as a branch for U.S. tax purposes, treating the hybrid entity as the "plan sponsor" in effect does nothing more than describe which income is looked at in determining whether "substantially all" of the corporation's income is treated as subject to a comprehensive foreign income tax. We believe this is within the regulatory authority of Treasury and the Service.[152]

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[150] *See* Section 7701(a).

[151] Section 7701 applies under the condition that a different meaning is not "otherwise distinctly expressed or manifestly incompatible" with the intent of the Code. While this exception is not applied frequently, it is not unheard of that the general definitions contained in Section 7701 are considered not applicable when used in various Code provisions. *See,* e.g., *Suzanne J. Pierre v. Commissioner*, 133 T.C. No. 2 (August 24, 2009), 2009 TNT 162-4, (holding that applying the entity classification rules under the Section 7701 regulations in the context of Federal gift tax valuation would be "manifestly incompatible" with the Federal estate and gift tax statutes); *Bunnel v. Commissioner*, 50 T.C. 837 (1968) (shareholders of S-corporation held to be "taxpayers" for purposes of determining to whom notice was required to be sent, despite the fact that the subchapter S corporation arguably also met the criteria of the definition of "taxpayer" in Section 7701(a)(14)); *see also* FSA 200117019 (June 24, 2001) (holding that treating a domestic corporation, which had obtained a charter in a foreign jurisdiction, even if it retained its U.S. charter, as domestic corporation would be manifestly incompatible with the intent of the consolidated return rules, the dividends received deduction and the subpart F regime).

[152] This is the same regulatory authority that allowed Treasury, in the Notice, to treat dividends paid by a subsidiary (where the subsidiary had substantially all of its income subject to a comprehensive foreign income tax) as not being excluded "nonresidence source income" even if such dividend income is, in fact, excluded from income of the parent corporation and not taxed. Notice Q&A-8(c)(iv).

3. Multiple Plan Sponsors

Proposal

If in applying the above rules one or more entities may constitute plan sponsors, it would be appropriate and helpful for guidance to clarify that if one of the plan sponsors is a nonqualified entity, such status would only affect the portion of the compensation with respect to which the deduction would be attributable to such plan sponsor and not the entire deferred compensation amount. We believe an array of reasonable allocation methods ought to be permissible. In addition, a *de minimis* exception could be provided for compensation plans among affiliates, specifying that Section 457A is not applicable if no more than a stated amount (e.g., 5 percent) of the compensatory amount is allocated to nonqualified plan sponsor entities.

Discussion

As currently drafted, it is not clear how to apply Section 457A to a plan, for which more than one entity is the plan sponsor. A situation of multiple plan sponsors may arise, for example, where the employee is entitled to benefits under separately maintained plans of a multinational group. Or, a multinational group may allocate the expense attributable to the performance of its employees among its affiliates based on the amount of work provided by a particular employee for a particular member of the group. (For example, imagine an executive that generally works in the United States, is seconded to one affiliate for six months, and spends three years as an expatriate with another affiliate, all the while accruing benefits under a worldwide nonqualified pension plan.) In many cases, foreign transfer pricing principles would apply to determine the amount of compensation expense that may be deducted in a specific tax jurisdiction. The statute provides for the application of aggregation rules to service recipients, but does not contain allocation rules.

We recommend that guidance clarify that if one of the plan sponsors is a nonqualified entity, such status would only affect the portion of the compensation with respect to which the deduction would be attributable to such plan sponsor and not the entire deferred compensation amount.

The Blue Book acknowledges the interrelation of the aggregation and allocation rules: "Entity aggregation rules similar to those that apply under Section 409A apply for purposes of the provision. … It is intended, however, that the Secretary may permit or require (as appropriate under the circumstances) that the determination of nonqualified entity status be performed on an aggregated basis, for example in the case of an aggregated group of entities that are organized in the same jurisdiction. Further, the determination of whether a nonqualified deferred compensation plan is a plan of a particular entity does not depend on whether such entity is aggregated with another employer that adopts and maintains the plan, but is instead determined generally on the basis of which entity is entitled to deduct compensation that is deferred under the plan."

Unfortunately, there are no comparable allocation rules under Section 409A that one could look to for guidance. This is not surprising, as Section 409A focuses on whether the compensation plan is compliant with Section 409A, but not which entity or service recipient

bears what portion of the compensation expense. In the compensation area, allocation rules exist, for example, for purposes of allocating compensation income of a nonresident alien between U.S. source and foreign source income.[153] Similarly, transfer pricing rules impose limits on the deductibility of compensation paid to employees who are really providing services to foreign affiliates.

We propose that Treasury and the Service permit an array of reasonable allocation methods. Such allocation methods may be based on the time spent performing services for a particular plan sponsor or the value of the services in relation to overall services performed. These allocation methods should include not only the initial allocation of the amount of nonqualified deferred compensation but also (to the extent relevant) allocations of notional earnings.

Finally, there should be a *de minimis* rule. For example, Section 457A should not apply to a nonqualified deferred compensation plan as long as no more than 5 percent of the compensation is attributable to a nonqualified entity.

B. Reimbursement Arrangements

Background

We understand that Treasury and the Service are concerned that taxpayers may try to avoid the application of Section 457A to nonqualified deferred compensation plans through the use of reimbursement arrangements, where the deferred compensation plan is sponsored by a qualified entity, but where the qualified entity is reimbursed by a nonqualified entity that is the ultimate beneficiary of the services. The Notice requests comments regarding the extent to which a reimbursement arrangement with respect to a domestic taxpayer service recipient and a nonqualified entity that has agreed to share or reimburse the domestic taxpayer service recipient's compensation costs should result in the domestic taxpayer service recipient also being treated as a nonqualified entity.

1. Definition of Reimbursement Arrangement

Proposal

We recommend that Treasury and the Service define the types of reimbursement arrangements that are intended to be covered under Section 457A. We propose that the covered arrangements should include only arrangements where there is a direct correlation between the amount of the reimbursement payment by the beneficiary of the services to the service recipient and the compensation payment to the service provider by the service recipient.

Discussion

While we are sympathetic to the concept that the entity that is (directly or indirectly) receiving services and is bearing the cost of compensation should be treated as the plan sponsor,

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[153] *See* Treasury regulation Section 1.861-4, which generally requires an allocation on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.

we believe that this sort of rule relating to reimbursement is only likely to be administrable where it is clear that there is a reimbursement. If, for example, one affiliate pays another for a service (e.g., research and development), some portion of that payment will be to reimburse employee compensation, but the payment may be based on the existing value of the R&D, or based on future profits, or may cover some indeterminate allocation of the employees' time.

For example, a multinational company headquartered in the United States employs software engineers that develop software that ultimately gets used by all of its affiliates worldwide. The affiliates pay royalties to the U.S. parent that are determined based on a share of profits derived from the use of the software in the respective affiliate's business. Should a portion of these royalty payments be viewed as being a reimbursement of the U.S. parent's employment expense?

We doubt that a rule requiring employee costs to be broken out of a more broadly defined arrangement or relationship will be administrable, and it will in the best of circumstances generate enormous uncertainty as to which entity should be looked at as the plan sponsor. To the extent Treasury and the Service feel that it is necessary, an anti-abuse rule applying to arrangements the principal purpose of which was to avoid Section 457A may be workable, although at a cost of increased uncertainty.

2. Reimbursement Arrangements Between Related Parties

Proposal

We recommend that Treasury and the Service clarify that in the case of reimbursement arrangements, if the reimbursement arrangement is between related parties,[154] Section 457A should apply to the portion of the nonqualified deferred compensation allocable to the nonqualified entity under the same principles outlined above for multiple plan sponsors. Where the intermediate service recipient is a U.S. taxpayer, such intermediate entity should be treated as conduit. In other words, the domestic intermediate service recipient should be in the same tax position it would have been in had the compensation expense simply been allocated to the foreign affiliate as described with respect to multiple plan sponsors, and the compensation deduction disallowed.

Discussion

Reimbursement arrangements among affiliates are common and in of themselves not abusive. Rather, the relevant transfer pricing rules may actually require such arrangements. For example, it is not uncommon that multinational corporations have employees that may be formally employed in one location (the home office), but as part of their employment, spend considerable amount of time either working abroad, or from the home office, for a foreign affiliate. Their compensation, including deferred compensation plans, are all paid out of the entity where the home office is located. Often, the foreign affiliate, however, may reimburse the

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[154] As transfer pricing rules will generally be applicable, we suggest parties be considered related for these purposes if and only if they are part of the same controlled group for purposes of Section 482.

home office entity for all or part of such employment cost, or alternatively, a tax authority may require such reimbursement (or allocate the expense to the foreign affiliate).

We believe that it is appropriate that Treasury and the Service promulgate rules regarding the treatment of such arrangements. We acknowledge that taxpayers may enter into such arrangements in the hopes of avoiding the application of Section 457A by having a domestic or other qualified foreign entity as the formal sponsor of a nonqualified deferred compensation plan, even though the costs of such arrangements are ultimately borne by a nonqualified entity.

We believe that reimbursement arrangements amongst related parties should be treated as if the intermediate service recipient were merely a conduit passing compensation from its affiliate to the service provider. This would cause such arrangements to be treated the same as allocation arrangements, which is appropriate as these have the same economic substance. Again, we believe an array of reasonable allocation methods ought to be available. However, one factor that should be considered in determining whether an allocation method is reasonable is whether a specific entity will be allocated an amount roughly equal to the excess of its compensation deduction over any offsetting income inclusion relating to (actual or deemed) reimbursement payments.

We recognize that this rule, like many other aspects of Section 457A, may be difficult to enforce. Very often the actual service provider will have either no knowledge of, or will not be able to influence, whether a nonqualified entity reimburses the costs of its formal employer. Even if there is no reimbursement arrangement in place, tax authorities may subsequently impute income to the domestic service recipient or allocate the expense attributable to the services performed for the foreign affiliate to such foreign affiliate. In either of these situations, the employee may be surprised to hear that Treasury and the Service would view the Hong Kong subsidiary of its U.S. employer as its actual employer and subject it to the rules of Section 457A. However, the solutions we suggest for other fairness and administrative concerns should also be helpful in this context. Specifically, the service recipient (or an affiliate thereof) must annually report to the service provider the amount of such service provider's nonqualified deferred compensation that is allocable to nonqualified entity affiliates. This allocation must correspond to any reimbursement arrangement actually in place and/or the transfer pricing position that will be taken by the service recipient on its tax returns. If the service provider acts in good faith reliance on the allocations reported to it, and does not know or have reason to know that the allocations are fraudulent or unreasonable, the service provider should be protected from Section 457A. Moreover, the service provider should be protected from the application of retroactive redeterminations made by tax authorities.[155]

The Notice appears to suggest that in case of reimbursement arrangements, Section 457A may apply twice – that is, to the reimbursement arrangement between the nonqualified entity and the domestic taxpayer service recipient (i.e., treating the domestic entity as the service provider) and to the nonqualified deferred compensation plan between the actual service provider and the nonqualified entity. In keeping with the principle that the intermediate service recipient should be treated as a conduit between the service provider and the nonqualified entity, the intermediate

[155] Of course, an exception should apply where the service provider can be held personally responsible for certain unreasonable or fraudulent tax positions taken by the plan sponsor. *See* Part II.A.

service recipient should be in the same tax position it would have been in were it entitled to neither the deduction nor the reimbursement. The domestic intermediate service recipient should never be allowed to accelerate its compensation deduction, notwithstanding the acceleration of the service provider's income inclusion.[156] However, the reimbursement payment should not be included in taxable income when received, as the domestic entity would otherwise be taxed twice on this amount. Similarly, to the extent that the amount paid to the service provider is nondeterminable, we do not think it would be appropriate to require both the service provider and the domestic entity receiving reimbursement to pay an additional 20 percent tax and underpayment interest.

3. Reimbursement Arrangements Between Unrelated Parties

Proposal

If the ultimate beneficiary of the services is an unrelated party, the relevant service provider subject to Section 457A should not be the employee who provided the services to the nonqualified entity that reimbursed the costs, but rather the domestic taxpayer intermediate service recipient, whose costs were reimbursed by the nonqualified entity. The intermediate service recipient should therefore be required to take the reimbursement into income currently, even though it will only receive a corresponding deduction when the compensation is received by the service provider.

Discussion

The rules outlined in the context of related parties are generally not appropriate in the context of unrelated parties, for the same reason that transfer pricing principles are not applied to transactions between unrelated parties.

Rather, in a reimbursement arrangement that does not involve related parties, Section 457A should only apply to the arrangement between the entity that benefited from the services and the entity that formally bore the expense and who received the reimbursement. Generally, the employee provides services to its employer, and if the employer is also a service provider, the employee provides services to another entity on the employer's behalf. Therefore the reimbursement should be considered compensation to the employer. If the reimbursement is made currently (i.e., on an annual basis), Section 457A should not apply, because there is no impermissible deferral (i.e., the nonqualified entity paid the cost currently). If the reimbursement is deferred (i.e., until the actual service provider receives payment from the domestic entity), Section 457A should apply to the arrangement and require the domestic service recipient entity to include the reimbursement amount in income at the time it is no longer subject to a substantial risk of forfeiture.

We do acknowledge that Section 457A can only be imposed on the service recipient whose costs are being reimbursed if such intermediate service recipient is a U.S. taxpayer.

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[156] In fact, the domestic intermediate service recipient should not be allowed to take the deduction even in the year that the compensation is paid. Instead the deduction will effectively be taken in the year the reimbursement is received, as such reimbursement will be excluded from taxable income.

However, we do not feel that there is as much potential for abuse where the ultimate service recipient and the intermediate service recipient are unrelated parties. Deferred compensation is only desirable to the service provider in situations where the service recipient is not a credit risk, and any intermediate service recipient attempting to act as a conduit for payments from the nonqualified entity to the service provider could pose a significant credit risk. Nonetheless, Treasury and the Service may wish to consider anti-abuse rules, similar to anti-conduit rules, so that purported third-party intermediate service recipients will not spring up in treaty jurisdictions with the intent of avoiding Section 457A. Such anti-abuse rules may apply, for example, in situations where the intermediate service recipient is structured in order to pass any credit risk of the ultimate service recipient on to the service provider and not interpose any additional credit risk.

C. Treaty Eligibility and Limitation On Benefits

Background

A foreign corporation is a nonqualified entity, unless substantially all of its income is (i) effectively connected with the conduct of a trade or business in the United States or (ii) is subject to a comprehensive foreign income tax. According to Section 457A(d)(2), the term "comprehensive foreign income tax" means, with respect to a foreign person, the income tax of a foreign country if (i) the person is eligible for the benefits of a "comprehensive income tax treaty" between the foreign country and the United States (hereinafter, the "treaty test"), or (ii) the person otherwise demonstrates to the satisfaction of the Secretary that the foreign country has a "comprehensive income tax" (hereinafter, the "tax system test"). The statute does not define the terms "comprehensive income tax treaty" or "comprehensive income tax."

Pursuant to the Notice, all treaties in force as of the date of publication of the Notice, other than the income tax treaties with Bermuda and the Netherlands Antilles, qualify as "comprehensive tax treaties" for purposes of determining whether a person meets the treaty test prong of the comprehensive foreign income tax test.[157]

Notice Q&A-10 requires that in order to meet the treaty test the foreign person must be a resident within the meaning of such term under the relevant tax treaty and must satisfy any other "relevant requirements of that treaty, including the requirements under any applicable limitation on benefits provision."[158] It is unclear which requirements would be "relevant" and which

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[157] *See* Notice Q&A-10. The United States has currently income tax treaties in effect with the following countries: Australia, Austria, Bangladesh, Barbados, Belgium, Canada, China (but not including Hong Kong), Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakhstan, Korea (R.O.K.), Latvia, Lithuania, Luxembourg, Mexico, Morocco, Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, South Africa, USSR (with respect to certain former Soviet Republics), Spain, Sri Lanka, Sweden, Switzerland, Thailand, Trinidad and Tobago, Tunisia, Turkey, Ukraine, United Kingdom and Venezuela.

[158] The Blue Book indicates that the Secretary will provide guidance on the issue of which U.S. income tax treaties are considered comprehensive income tax treaties. One factor to be taken into account in this guidance will be whether a particular income tax treaty includes comprehensive limitation on benefits rules. The Blue Book states that "[A] treaty with liberal, or no, limitation on benefits rules (such as the present treaties with Hungary and Poland) may in the Secretary's discretion, be excluded from treatment as

limitation on benefits provisions would be "applicable." The Notice expressly requests comments whether and to what extent an LOB provision or exchange of information program is relevant to the determination of what is a "comprehensive income tax treaty."

1. **Most LOB Provisions are Not Relevant**

Proposal

We propose that Treasury and the Service issue guidance that provides that for purposes of applying the treaty test, the relevant person is not required to satisfy the LOB provisions of the specific tax treaty. Rather, the guidance should provide that it be sufficient if the person (i) qualifies as a resident of a treaty jurisdiction, as the term "resident" is defined in the treaty and (ii) meets a certain limited base erosion test (as described below).

Discussion

It is far from clear why qualification for limitation of benefits under an income tax treaty is relevant, at least as a general matter, for purposes of Section 457A. Certain examples can best illustrate this point:

Example: Assume a Mexican subsidiary corporation provides deferred compensation under a nonqualified deferred compensation plan to a U.S. employee. The Mexican corporation is owned by a U.K. corporation that is wholly owned by U.K. resident individuals. The Mexican corporation will not qualify for all benefits under the U.S. - Mexican treaty unless, very generally, it is publicly traded or it meets both an ownership and base erosion test (but see discussion of active trade or business LOB clauses below). The Mexican corporation in this example is neither publicly traded, nor can it meet an ownership test, because it is not owned directly or indirectly by Mexican, U.S. or other NAFTA residents.

Similarly, a U.K. corporation subject to U.K. tax but owned by two residents of the UAE will not qualify for all benefits of the U.S. - U.K. tax treaty. These foreign corporations in question are generally subject to a comprehensive foreign income tax but become disqualified (at least under the treaty test) merely as a result of the tax residence of their shareholders, which seems an unfair result. This would even be an unfair result if all of the corporation's shareholders were Cayman Islands residents, because this has no effect on whether the plan sponsor pays tax under a comprehensive income tax regime.

This issue will also arise in the context of a foreign corporation that receives dividends from a subsidiary incorporated in another foreign jurisdiction, and there is a question of whether dividends from that subsidiary should be treated as excluded nonresidence income. (Under the Notice, dividends from a subsidiary are not treated as excluded nonresidence source income,

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comprehensive income tax treaty because a corporation may be eligible for the benefits of that treaty even it most or all of its income is not subject to tax in the corporation's country of residence." The Blue Book further explains that guidance issued on what constitutes a comprehensive income tax treaty under Section 1(h)(11) should in no way be considered to bind any guidance issued under Section 457A. *See* Blue Book at 531, n. 881. We think that the latter point is wrong as a matter of statutory interpretation and note that this language did not appear in any legislative history that predates the statute's passage.

even if *actually* excluded from income under foreign law, if the subsidiary has substantially all of its income subject to a comprehensive foreign income tax under the same general rules.) If, for example, the U.K. corporation that is the plan sponsor receives dividends from its Mexican subsidiary and excludes them under a participation exemption, then those dividends will be treated as excluded nonresidence source income because the Mexican subsidiary does not satisfy the LOB article of the U.S. - Mexican treaty, even if the Mexican subsidiary would, if it had been owned by U.S. persons, have been treated as being subject to a comprehensive foreign income tax.

LOB provisions of tax treaties are driven by a concern that the foreign person should have sufficient nexus with the treaty jurisdiction or eligible jurisdiction beyond residence. This concern with nexus does not appear relevant for purposes of Section 457A. Consequently, it would be more appropriate to require solely that the nonqualified entity be a resident of a jurisdiction that has a comprehensive foreign income tax treaty with the United States. We do not believe that Treasury and the Service lack the authority to disregard LOB provisions where relevant, under the broad grant of authority in Section 457A(e) and in the authority granted in Section 457A(d)(2)(B) allowing entities that are not eligible for the benefits of a tax treaty to otherwise satisfy the Secretary that a foreign country has a comprehensive income tax.

In order to ensure, however, that "substantially all of the income" of the foreign corporation is subject to tax in its country of residence, it seems reasonable to apply some sort of base erosion test. After all, income excluded by means of deductions is no more taxable than income excluded due to its nonresidence source. However, we do not believe that it would be appropriate to apply a conventional base erosion test as is found in many tax treaties (i.e., whether more than a certain amount of the gross income of such person is used directly or indirectly to make deductible payments to persons who are not eligible for treaty benefits). Such a test would raise significant compliance issues, as it would require detailed information about the payees of deductible payments by the plan sponsor (which, in the case of publicly traded debt securities or widely participated bank loans may well be impossible). Also, in general Section 457A does not look to whether an entity is an *actual* taxpayer (e.g., whether it has substantial net operating loss carryovers or other substantial ordinary course deductions or credits that make it tax-indifferent) but rather whether it is of a type that would in the abstract be considered a taxpayer. Using a base erosion test of the sort generally found in treaties would draw arbitrary lines between treaties (which do not have uniform LOB provisions) and between entities that have deductible payments made to residents of one jurisdiction and entities that have deductible payments made to residents of another jurisdiction, or to unknown persons.

Consequently, we suggest a more narrowly drawn base erosion test that is generally applicable for purposes of Section 457A (presumably for purposes of entities trying to qualify under Section 457A(d)(2)(B) (i.e., the tax system test) as well as Section 457A(d)(2)(A) (i.e., the tax treaty test). The Tax Section's Executive Committee did not come to a conclusion as to the parameters of such a base erosion test, other than the belief that it should apply in a manner such that entities structured so as to pay no more than marginal income tax even though generally eligible for treaty benefits (e.g., Irish Section 110 Companies[159] or Luxembourg SARLs using

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[159] A "Section 110 Company" is a special purpose vehicle in Ireland formed for the purpose of owning "qualifying assets" (e.g., stock, bonds, securities, various derivatives). Although resident in Ireland and

PECs/CPECs[160] to generate deductions) should not be treated as subject to a comprehensive foreign income tax.[161] One suggestion would be to take into account deductible payments the amount of which is substantially correlated to the income or profits of the service recipient (e.g., deductible profit participating loans or deductible royalty payments measured in relation to profits). Another suggestion would be to take into account payments with respect to "hybrid" instruments treated as equity for U.S. tax purposes but giving rise to deductible payments for foreign law purposes (e.g., mandatorily convertible debt instruments, or debt issued by thinly capitalized issuers). A third suggestion would be to apply a thin capitalization test.[162]While creating uniform standards involves the risk of over- or underincluding plan sponsors from the application of Section 457A, such approach is nevertheless preferable as it is more easily administrable, leads to results that make policy sense, and more clearly delineates the type of entities that should not be eligible for qualifying for the treaty test or tax system test.[163]

2. Active Trade or Business

Proposal

If Treasury and the Service believe that due to the wording of the statute, which requires that the foreign person be "eligible for the benefits of a comprehensive income tax treaty," it would not be possible to abolish the requirement that the relevant person qualify under the LOB clause of the specific treaty, guidance should provide that a person that has substantial business activities in the treaty jurisdiction qualifies for the so-called trade or business LOB clause of the

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subject to Irish tax at a 25 percent rate, these companies generally pay out all or substantially all of their income in the form of deductible expenses, reducing their tax base to a *de minimis* amount. Moreover, the equity capitalization of these entities is often nominal and held by a charity, with the "real" equity assuming the form of a contingent note or other security that provides for debt service or other deductible payments equal to the anticipated net profits of the entity.

160 PECs (preferred equity certificates) or CPECs (convertible preferred equity certificates) are hybrid financial instruments that are typically used in a cross-border context to finance Luxembourg holding companies. Under Luxembourg tax law, these instruments qualify as debt for capital duty and for corporate income tax and net wealth tax purposes. Consequently, payments or accruals made under the PECs or CPECs are, similar to interest payments, deductible from the tax base of the Luxembourg entity and are exempt from withholding tax. The tax laws of at least some jurisdictions treat these instruments as equity and thus payments received under PECs and CPECs are viewed as dividend income falling within the scope of domestic tax exemptions. The majority of the capitalization of a Luxembourg holding company can be in the form of these instruments with very little equity so that only a small spread after the deductible payments is subject to tax in Luxembourg.

161 Many such companies would be treated as nonqualified entities under other provisions in any event, because subject to a "materially more favorable regime or arrangement" (e.g., Irish Section 110 Companies), or because they have substantial nonresidence source income treated as "excluded." It is therefore not necessary to rely solely on a base erosion test to identify tax-indifferent entities.

162 We recommend that any such thin capitalization ratio be designed to identify entities capitalized in such a manner that it is commercially unreasonable to expect that they will pay substantial income tax, and not catch entities with a capital structure that an ordinary operating company (including financial institutions) might have in practice.

163 *See also* our "Report on Proposed Carried Interest and Fee Deferral Legislation" (Report No. 1166, Sept. 24, 2008), in which these principles were discussed in relation to the legislation when still in its proposed form.

treaty if all the compensation paid to the service provider qualifies as sufficiently connected with such trade or business conducted in the treaty jurisdiction, applying the general principles of the LOB clause.

Discussion

Because the statute has language that suggests that the foreign person must meet the requirements under an LOB clause, Treasury and the Service may determine that it does not have statutory authority to abolish such requirement for purposes of applying the treaty test.[164] If that is the case, we recommend as an alternative that guidance clarify how qualification for a limited LOB clause affects the application of Section 457A.

In particular, many U.S. tax treaties provide that a foreign corporation satisfies the LOB provision of the treaty with respect to an item of income derived from the U.S. if the income is connected with an active trade or business conducted by the foreign corporation in the treaty jurisdiction (the "trade or business LOB" clause). This is a limited LOB clause in that the benefits of the treaty only apply to income derived from the other jurisdiction to the extent it is connected to a trade or business in the jurisdiction of residence. The application of such trade or business LOB clause therefore presupposes that the foreign corporation actually receives U.S. source income. However, this may not always be the case when testing for nonqualified entity status under Section 457A.

Assume the above example of the U.K. corporation with the Mexican subsidiary. The only way the Mexican subsidiary could qualify for treaty benefits under the U.S. - Mexico treaty is if income derived from the U.S. is connected to its business activities in Mexico. However, the fact that the Mexican subsidiary may not derive income from the U.S. and therefore would never qualify for treaty benefits under the trade or business LOB clause should not make the Mexican corporation with substantial business activities in Mexico a nonqualified entity.

While we feel the trade or business LOB clause should be irrelevant for purposes of Section 457A, if Treasury and the Service feel that they are required to apply LOB provisions, an entity should be treated as "eligible for treaty benefits" even if it derives no U.S. source income in connection with that trade or business, and fails to qualify for all benefits of the treaty under other LOB provisions, as long as (1) the entity has an active trade or business in the jurisdiction in which it is a tax resident and/or (2) the compensation paid to the service provider qualifies as sufficiently connected with the trade or business conducted in the treaty jurisdiction.

To address concerns of abuse (i.e., compensation arrangements being funded by companies resident in treaty jurisdictions that engage in *de minimis* business activities in the treaty country), Treasury and the Service could interpret the term "trade or business" in the trade or business LOB clause as applied under the proposal set forth herein consistently with the manner in which it is applied in the treaty context. That is, whether a plan sponsor is engaged in an "active trade or business" in a treaty jurisdiction can be determined by reference to the regulations under section 367(a) (for the definition of the term "trade or business"), including by requiring that the officers and employees of the corporation conduct substantial managerial and

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[164] Section 457(d)(2)(A).

operational activities.[165] Moreover, consistent with most tax treaties that exclude the managing of investments for the resident's own account from the definition of a trade or business for purposes of this clause, such activities should be considered to be a trade or business only when part of banking, insurance or securities activities conducted by a bank, insurance company or a registered securities dealer. This would also exclude headquarters companies from qualifying for this LOB clause.

However, where the relevant deferred compensation is allocable to the trade or business, we believe that guidance should clarify that the activities need not be substantial (generally an additional condition in a traditional trade or business LOB clause)[166] and it would appear appropriate to allow the application of attribution rules to the extent provided in a treaty in determining whether a person is engaged in the active trade or business.[167] Where the relevant deferred compensation is allocable to the business activities, the relative size of a business should be irrelevant for purposes of Section 457A, since the smaller the size of the business, the less deferred compensation expense that could properly be allocable to it.

3. Applicability of Tax System Test to Residents of Treaty Jurisdictions

Proposal

If LOB provisions must be applied for purposes of the tax treaty test, guidance should clarify that an entity resident in a country which has a comprehensive income tax treaty with the United States (but which does not meet the LOB provisions of such tax treaty)[168] can "demonstrate to the Secretary" that it is a resident of a country that has a comprehensive income tax, thereby avoiding nonqualified entity status under the tax system test.

Discussion

Congress intended that it be easier, not harder, for residents of comprehensive income tax treaty countries to demonstrate they are subject to a comprehensive income tax. Accordingly, such entities should be allowed to qualify under the tax system test even if they fail the tax treaty test. Indeed, it is unclear on what grounds the Secretary could be unsatisfied with an entity that is a "resident" of a comprehensive income tax treaty country, as that term is defined in the treaty, as all such treaty countries have a comprehensive income tax.

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[165] The term "trade or business" is generally not defined in U.S. tax treaties. Consequently, U.S. competent authorities ascribe to this term the meaning that it has under U.S. law.

[166] This substantiality requirement is intended to prevent a narrow case of treaty shopping abuses in which a company attempts to qualify for benefits by engaging in *de minimis* connected activities in the treaty country in which it is resident.

[167] *See*, e.g., Art. 21(4)(c) of the U.S. - Belgium tax treaty, which attributes activities of persons "connected" (in general through 50 percent or more beneficial ownership) to the person being tested for qualification under the clause.

[168] Obviously if Treasury and the Service were to adopt the limited base erosion test described in Part III.C.1 also for purposes of the tax system test, the entity would need to meet the limited base erosion test in order to satisfy the tax system test.

D. The Tax System Test

If a person does not meet the tax treaty test, such person must demonstrate to the satisfaction of the Secretary that substantially all of its income is subject to tax in a foreign country that has a "comprehensive income tax." The Notice does not provide how Treasury and the Service intend to determine, and how a person should establish, that it meets this tax system test. Regardless of which approach Treasury and the Service choose, we believe it is important that Treasury and the Service provide some form of guidance, as otherwise as a practical matter the tax system test will be read out of the statute.

1. Designating which Countries Impose Comprehensive Income Taxes

Proposal

We recommend that Treasury and the Service either publish a list of countries with "comprehensive foreign income taxes" or provide for a list of relevant factors (e.g., countries with corporate tax rates in excess of 90 percent of the U.S. rate) in order to determine which jurisdictions that have not entered into tax treaties with the United States have a "comprehensive foreign income tax."

Discussion

Requiring obtaining rulings on a company-by-company basis would seem administratively impracticable. Although we understand from various public statements by Treasury officials that the Secretary does not intend to issue a list of countries whose tax systems meet such requirements, we cannot imagine that the Service wishes to be inundated with private ruling requests, especially since the Service generally avoids granting private rulings on factual, as opposed to legal, issues. To avoid such an administrative burden (both for the Service and for taxpayers), we recommend that Treasury issue a list of countries, such as Brazil, Argentina, etc. that should be considered to have a comprehensive income tax or alternatively, formulate a list of relevant characteristics that a jurisdiction's tax system should have.

The former proposal would require Treasury or the Service to analyze the tax systems of various jurisdictions. However, we believe that there is only a limited number of jurisdictions that would need to be analyzed under the tax system test. These are jurisdictions that currently (for whatever reason) have not entered into tax treaties with the United States but that have an income tax system. Jurisdictions that generally do not impose an income tax, such as the Cayman Islands, Bermuda, etc. would in any event be excluded from this alternative. Moreover, Treasury or the Service would be required to undertake such analysis in any event even if it would opt for the alternative of requiring rulings on a company-by-company basis. Also, declaring a jurisdiction to meet the comprehensive income tax test is only the first step of the analysis. The taxpayer would still need to meet the less than 20 percent excluded income test.

Alternatively, if Treasury and the Service do not intend to provide a list of qualifying jurisdictions, guidance should clarify the relevant characteristics that a jurisdiction's tax system should have in order to be considered "comprehensive." Relevant factors could be a tax rate in excess of 90 percent of the U.S. tax rate; the existence of anti-thin capitalization rules, a broad tax base that looks to gross income from any sources of activities, etc. Alternatively, using

GAAP or IFRS as proxy for income, one could treat any company that pays more than x percent of its GAAP or IFRS income in foreign tax as being subject to a comprehensive income tax system. Moreover, in addition to requiring that substantially all of the entity's income be subject to tax in a jurisdiction whose tax system has all the relevant characteristics, Treasury and the Service can backstop abuses by requiring that the entity also meet the limited base erosion test described in Part III.C.1 above.

2. Ruling on a Company-by-Company Basis

Proposal

If Treasury and the Service insist on having the Service grant rulings on a company-by-company basis, detailed guidance is required as to the application process and the types of supporting information and documentation that is required to meet the burden of proof.

Discussion

If the Service is to issue rulings, it will be necessary to promptly issue detailed procedures addressing how the relevant taxpayer can demonstrate that the tax system of a specific jurisdiction satisfies the tax system test. First, it is currently unclear as to who would be required to make the application. The statute requires that the entity tested for its nonqualified entity status make the relevant demonstration. How can an independent contractor or an employee in a non-managerial position force the service recipient to make such application? Moreover, it is unclear as to the type of supporting documentation required. Will the Secretary require opinions of local counsel? What are the relevant criteria that make a tax system a "comprehensive income tax"? Is it the tax rate, the comparability of the tax base to the U.S. tax base, etc.? Guidance will need to address these and other similar questions.

Even if Treasury and the Service do not adopt any of the recommendations set forth above, it is essential that it provide some form of guidance in order to allow taxpayers to qualify under the tax system test. The absence of guidance will substantially diminish the ability of a taxpayer to rely on this alternative determination of the comprehensive foreign income test.

3. Tax Residency

Proposal

As long as substantially all of the income of an entity is subject to tax in a qualifying jurisdiction, it should not matter on which basis (i.e., residence or the conduct of a business in that jurisdiction) such tax is being imposed.

Discussion

While the statute only requires a showing as to the comprehensiveness of a foreign country's income tax system, the Notice also requires that the foreign corporation demonstrate that it is a resident for tax purposes in such a qualifying jurisdiction. We question the necessity of going beyond the statute to require that the foreign person is a tax resident in a qualifying jurisdiction. The focus of the test is that income of a plan sponsor subject to tax in a jurisdiction

that has a comprehensive income tax system counts towards the "substantially all" requirement.[169] An entity formed in a tax haven jurisdiction may be subject to tax in a non-tax haven jurisdiction based on its activities therein without necessarily being treated as a resident of such jurisdiction. If substantially all (e.g., 80 percent) of its income is subject to tax, the entity should not constitute a nonqualified entity. We propose therefore that this additional residence requirement added by the Notice be removed.

E. <u>The 20 Percent Excluded Income Test</u>

<u>Background</u>

While the statute does not specify what it means for "substantially all" of a foreign corporation's income to be "subject" to a comprehensive foreign income tax, the Notice interprets this as a requirement that no more than 20 percent of a foreign corporation's taxable income be "nonresidence source income" (i.e., income derived from sources outside the residence of the relevant taxpayer) that is excluded from tax in the corporation's country of residence ("excluded nonresidence source income").

Currently, under the Notice, for purposes of the 20 percent test, the numerator equals excluded nonresidence source income (determined under the principles of Section 61), other than income that falls under certain limited exceptions. The denominator equals the foreign corporation's gross income as determined under the laws of the foreign corporation's country of residence plus all nonresidence source income to the extent not otherwise included in such foreign corporation's gross income. Accordingly, the denominator would not include income sourced in the foreign corporation's country of residence that is excluded from gross income under foreign law, but included in gross income under Section 61 principles. For example, the income of a hybrid subsidiary organized in the same jurisdiction as the parent would not be included in the denominator. By contrast, the income of any hybrid subsidiaries organized in other jurisdictions may be included because such income is nonresidence source income.

While we agree this principle is one plausible interpretation of congressional intent, the specific rules for applying the test need to be clarified.

1. <u>Meaning of "Exclusion from Tax"</u>

<u>Proposal</u>

We recommend that Treasury and the Service provide greater clarification as to what precisely is treated as an "exclusion" of income, and that certain specific items (foreign tax credits and deductible payments) should in general not be treated as "exclusions" from income.

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[169] Income effectively connected with the conduct of a trade or business in the United States also counts towards the "substantially all" requirement. That is, a foreign corporation with income that is half ECI, and half subject to a comprehensive foreign income tax, clearly meets the "substantially all" requirement. The Notice implicitly takes this view by exempting ECI from the calculation of the "excluded amount" of nonresidence source income.

Discussion

Notice Q&A-8(c)(i) includes a very broad definition of excluded income, and then provides very narrow exceptions in Notice Q&A-8(c)(iv) for certain dividends and ECI. In particular, an item of nonresidence source income is treated as excluded if "the taxable income does not include such income, or excludes such income by means of exemption, exclusion (including an exclusion from gross income), deduction (including a dividends received deduction or dividends paid deduction (or similar provision)), by means of taxation of such income at a rate of tax less than 50 percent of the generally applicable rate, or by other means." The exceptions indicate recognition by Treasury and the Service that nonresidence source income should not be treated as "excluded" if it has already been subject to U.S. income tax or a comprehensive income tax in a third jurisdiction.

As drafted, the Notice is vague and ambiguous as to what might constitute an "exclusion" of income, outside of the obvious cases. As a practical matter, particularly in light of the relatively small (20 percent) amount of nonresidence source income that can be excluded, taxpayers will need to have substantial certainty whether or not there is an item of nonresidence source income that is excluded. The uncertainties may lie in whether or not there is an item of income (or how much income there is), or in whether the income is nonresidence source income, or in whether it is "excluded." Because the application of the "substantially all" rule is not conceptually related to the apparent focus of Section 457A, it will be difficult for taxpayers or the Service to determine these questions on the basis of the fundamental purpose of the provision.[170] The primary recommendation, therefore, is for there to be clear rules that can be applied in a wide range of foreign tax regimes. We suggest that the very general catch-all phrase in the Notice should be deleted in its entirety, or at a minimum replaced with a phrase that is more narrowly tailored and provides more guidance on what is intended to be covered, e.g., "or other mechanisms that have the functional result of excluding gross or net income."

In addition, we have some specific recommendations regarding "exclusions" from income:

170 We assume that Section 457A is intended to identify service recipients that are relatively tax-indifferent to the timing of the deduction for compensation. For this purpose it appears that whether the service recipient has a significant percentage of excluded income is entirely irrelevant; what is relevant is whether or not the service recipient has or may reasonably have gross taxable income against which the compensation expense may be deducted. So long as the service recipient has taxable income in an amount no less than the amount of compensation expense, then the service recipient is not indifferent. In fact, the compensation deduction will have a greater impact as a percentage of the corporation's total tax liability if the corporation has less taxable income. For example, assume the following foreign corporations are subject to the same tax rate and each have 20 of compensation expense that is deductible: corporation A has 100 of gross taxable income, corporation B has 100 of gross taxable income and 9,900 of tax sheltered income, and corporation C has 10,000 of gross taxable income. Under the Notice, corporation B is a nonqualified entity. Arguably, however, corporation C will care less about the timing of the compensation expense than corporation B will, because the deduction would have a much smaller impact on corporation C's effective tax rate, whereas the deduction would have the same impact on corporation B's effective tax rate as on corporation A's. Assuming no other deductions or losses, each corporation would have the same tax savings in absolute terms. (The existence of other deductions could in theory be relevant, but neither the Notice nor the statute suggest that a service recipient that is not a taxpayer due to excess losses should be treated as a nonqualified entity. Barring an income stripping scheme, one can assume a corporation does not deliberately incur losses in order to avoid taxes.)

- First, we assume that despite the catch-all phrase "or by other means," Treasury and the Service did not intend to pick up nonresidence source income that is excluded by means of foreign tax credits similar to those available under the United States foreign tax credit regime (e.g., tax credits reflecting actual payments made to a foreign jurisdiction). This should be clarified. In this regard we do not believe that Section 457A should be concerned with the details of the foreign tax credit system (e.g., limits on cross-crediting, carry-forwards or carry-backs, technical taxpayer rules or the like), so long as the credit relates to actual tax payments made (i.e., excluding tax sparing credits or similar deemed credits).

- Second, we believe that the inclusion of a "dividends paid deduction" in the list of exclusions is likely misplaced, because a dividends paid deduction is not necessarily tied to the amount of gross or net income received and so does not appear to be the equivalent of an income exclusion. While we do think that a dividends paid deduction is likely to cause a foreign corporation to be treated as being subject to a "materially more favorable" tax regime (and should be included in that analysis), its inclusion in the list of income exclusions is confusing.

- More generally, we question whether any deductible payments made by a foreign corporation ever should be treated as an exclusion of income (as contrasted to the "materially more favorable" tax regime test, or the modified base erosion test that the Report proposes for purposes of treaty residence). Such amounts will generally not be determinable by looking at the status of the entity, or the character of the income received, and instead will require an evaluation of potentially all of the transactions undertaken by the foreign corporation in the relevant year, and understanding how the transactions are treated from a foreign tax law perspective. For example, suppose a foreign corporation has borrowed stock in nonresident corporations, and it makes deductible substitute dividend payments – does that cause the gross dividends received to be treated as excluded income? If a foreign corporation has hedged a position in a nonresident corporation with a swap, do deductible payments under the swap cause gross dividends or interest to be excluded? If a foreign corporation has sold a participation in a loan or other asset, and under the law of the corporation's jurisdiction the foreign corporation is treated as receiving gross income on the loan and making a deductible payment on the participation, is the interest on the loan excluded gross income? How about deductible royalty payments related to nonresident sales? This list of questions is not meant to be comprehensive, but just to illustrate the variety of transactions that might, possibly, cause income to be treated as "excluded" – particularly if the relevant rule is drafted in a vague and potentially over-inclusive manner.

2. Treatment of Branches and Hybrid Entities

Proposal

In applying the 20 percent excluded income test to an owner of a "true" branch or a hybrid entity (i.e., an entity that is disregarded for U.S. tax purposes but treated as a foreign corporation under foreign law), where such branch or hybrid entity is not the plan sponsor, the branch or hybrid entity should be treated as a corporation for U.S. tax purposes. Where the entity is treated as a flow-through under foreign law (other than a true branch), the entity should also be treated as such for purposes of the 20 percent test.

Also, in situations where a jurisdiction excludes same country source income items (e.g., dividends from same country subsidiaries), the term "gross income" for purposes of the 20 percent exclusion test needs to include such items provided that they have been subject to at least one level of tax in the jurisdiction of the foreign corporation.

Discussion

Generally, it should not matter which country or countries a plan sponsor pays income taxes in, as long as substantially all of its income is subject to such comprehensive income tax. Therefore, a company receiving dividends from multiple foreign subsidiaries should not be nonqualified as a result of the exclusion of those dividends from such company's income tax liability if each of those subsidiaries was already subject to comprehensive income taxes. The Notice acknowledges this by excluding dividends from domestic subsidiaries and from subsidiaries substantially all of the income of which is subject to a comprehensive foreign income tax from the "excluded amount."

However, the Notice does not provide exceptions for many types of nonresidence source income that have similarly already been taxed —for example, income from branches in third-party jurisdictions or income of hybrid entities.

Currently, it is not clear how to apply Section 457A to a foreign parent corporation that has branches in countries outside its jurisdiction of residence, the income of which is subject to tax in such foreign countries, but is excluded from income in the home jurisdiction of the foreign parent.[171] For example, it would seem that under the Notice, a corporation resident in a foreign country that excludes from taxable income the income of nonresident branches (either under its domestic rules or under a tax treaty with the branch jurisdiction) may fail the 20 percent test, even when its tax liability would have been the same if the nonresidence source income had first

[171] The OECD Model treaty and all U.S. treaties include provisions governing the taxation of "business" profits earned by an enterprise. The general rule is that the country in which the enterprise is resident (residence country) has the exclusive jurisdiction to tax the business profits of the enterprise even if those profits are earned in another country (source country). The exception to this rule is if the enterprise maintains a "permanent establishment" (PE) in the source country. In that case, the source country is entitled to tax the business profits of the enterprise attributable to the PE. The residence country, in turn, is obligated to relieve double taxation of that income either through a foreign tax credit or exemption. Indeed, most countries with which the U.S. has entered into double tax treaties exclude active nonresidence source income from the domestic taxable base of corporations that are resident in such countries. Examples include Germany, France, Switzerland, Belgium, and the Netherlands.

been included in taxable income, and then credits given for the taxes paid by the nonresident branches. This outcome may adversely affect many foreign financial institutions that typically operate branches outside their jurisdiction of residence. It seems an inappropriate result and contrary to the underlying policy of Section 457A.

Example: A French bank operates branches around the world. Generally, the income from the non-French branches is exempt from French tax, unless (i) the branch is subject to local taxes that are less than half of the French corporate taxes that it would have had to pay had it been established in France and (ii) the branch is not established in an EU country. Assume each of the U.S., U.K., and Cayman branches is the employer under local law of several U.S. citizens that are entitled to nonqualified deferred compensation. Compensation paid to these employees is deductible against the bank's U.S., U.K., and French income tax liabilities, respectively. To determine whether the bank is a nonqualified entity, the income of each branch must be tested to determine whether it is excluded nonresidence source income that is part of the numerator of the 20 percent test. The Notice does not treat the income from the U.S. branch as excluded nonresidence source income because it is taxed in the U.S. as ECI. The employees of the U.S. branch are excluded from Section 457A under Section 457A(d)(4) (i.e., expense allocable to ECI). However, the income from the U.K. and other (non-French) European branches is treated under the Notice as excluded nonresidence source income. The employees of the U.K. and Cayman branches will be subject to Section 457A if these European branches' gross income constitutes more than 20 percent of the bank's global gross income. However, the income from the Cayman branch is subject to tax by France and therefore is not excluded nonresidence source income. Therefore, if more than 80 percent of the bank's global gross income was attributable to certain low-tax jurisdictions, and therefore subject to French income tax, the bank would not be a nonqualified entity. The preference for taxes paid to the jurisdiction of residence (here, France) seems arbitrary.

Moreover, in many situations the outcome would be different if the foreign branch were incorporated in the jurisdiction in which the branch's income is subject to tax or were a partnership for U.S. tax purposes. First, in the absence of controlled group aggregation rules, the nonqualified entity test is applied on an entity-by-entity basis. As long as the foreign parent corporation's taxable income (determined under the laws of its country of residence) does not include the income of a subsidiary (unless the subsidiary has paid a dividend to its parent), the determination would be made based solely on the foreign parent corporation's gross income. Second, dividends from a foreign corporation substantially all of the income of which is subject to a comprehensive foreign income tax are not included in the excluded amount for purposes of the 20 percent gross income test (and the relevant income there would be the net income reflected in the dividend payment rather than the gross income of the subsidiary). Similarly, the income of an entity treated as a partnership for U.S. tax purposes that is subject to tax in its country of residence may be treated (under certain circumstances) as allocated to itself for purposes of determining the nonqualified entity status of such entity. There is no similar provision in the Notice for branches.

We believe that there are several ways of addressing the concern. First, as discussed below, the list of items of nonresidence source income that are not included in the excluded amount should be expanded to cover also income of a branch or permanent establishment provided such income is subject to a comprehensive foreign income tax (determined by treating

the branch as a foreign corporation). The items of nonresidence source income that are not included in the excluded amount could also be expanded to cover items of income that would expressly qualify for treaty benefits under the rule for "triangular cases," discussed further below.

Alternatively, a branch or permanent establishment should in general be treated as a corporate subsidiary for purposes of applying Section 457A. As discussed above, this would mean that the nonqualified entity determination could be applied at the branch level where the branch is the sponsor of the plan (i.e., bears the cost of the compensation) applying foreign tax principles; or alternatively if the determination is made at the parent level (because the branch is not the plan sponsor) would ensure that the parent is not disqualified provided that the branch is treated as subject to a comprehensive foreign income tax. This is consistent with the rule provided for partnerships, which allows the income of a partnership that is treated under the laws of a foreign country as resident in that country for tax purposes to be treated as allocated to itself.[172]

A similar problem arises when a foreign corporation holds interests in hybrid entities, which are disregarded for U.S. tax purposes, but treated as separate corporations under the tax laws of such corporation's country of residence. Under the proposal set forth in this Report, the foreign tax classification of these entities should prevail.

However, until such guidance is issued, Notice Q&A-8(b) defines "gross income" as the gross income as determined under the income tax laws of the foreign corporation's country of residence plus "all nonresidence source income of the foreign corporation to the extent not otherwise included in the foreign corporation's gross income." This may include income of a hybrid entity (regardless of whether distributed to the foreign parent) to the extent the U.S. tax classification of the entity prevails for purposes of this analysis. As described in the next subsection, we believe that foreign tax principles should apply. Moreover, as illustrated by the following examples, our proposal ensures that plan sponsors that are indifferent under foreign law to the compensation deduction are captured by Section 457A and that plan sponsors that are not indifferent escape the application of Section 457A.

Example 1: A U.S. taxpayer is employed by a BVI limited company. The BVI company is indirectly wholly owned by a Mexican corporation, through two of its subsidiaries. The Mexican parent corporation is eligible for benefits under the U.S. - Mexico tax treaty. However, assume the income of the BVI company is not taxed by Mexico on a current basis as income of the Mexican parent, and compensation paid to the BVI employees is not deductible on a current basis from the taxable income of the Mexican parent. Under the Notice, if the BVI company is treated as a corporation for U.S. tax purposes, it would be a nonqualified entity. If it is not treated as a corporation, but has elected to be treated as a partnership for U.S. tax purposes and assuming the subsidiaries owning the BVI company are not "eligible persons" under the Notice, the BVI company would be a nonqualified entity in this situation as well. In either of these cases, the BVI company is the relevant plan sponsor. However, if the BVI company and both subsidiaries are disregarded entities for U.S. tax purposes, under the Notice the Mexican parent will be treated as the plan sponsor. Provided no more than 20 percent of the Mexican parent's

172 *See* Notice Q&A-11(a), (b), (c), and (e)(iv).

gross income is treated as excluded nonresidence source income, the BVI employee will not be subject to Section 457A.

Example 2: Assume the same facts as example 1, except that the company is an NSULLC that is a resident of Canada instead of the BVI, and the parent is a resident of the Netherlands instead of Mexico. The NSULLC is taxed as a corporation in Canada, and compensation paid to the employees is deductible against its taxable income under Canadian law. However, the Canadian NSULLC only qualifies for benefits under the U.S. - Canada tax treaty with respect to income derived in connection with an active trade or business conducted in Canada, because it is not publicly traded, and it fails the ownership test of the LOB provisions of the treaty. If the Canadian NSULLC were treated as a corporation for U.S. tax purposes, it could be treated as a nonqualified corporation under the Notice, unless the active or trade or business is sufficient to qualify for LOB purposes. If the Canadian NSULLC is treated as a partnership for U.S. tax purposes, it is even less clear whether it would be a nonqualified corporation under the Notice (see discussion below on allocations of partnership income to itself). If the Canadian NSULLC is treated as a disregarded entity, the Dutch parent will be treated as the plan sponsor under the Notice. The Canadian NSULLC's income would probably be treated as excluded nonresidence source income of the Dutch parent (see discussion below on principles of Section 61). If the Dutch parent had too much excluded nonresidence source income, the employee of the Canadian NSULLC will be subject to Section 457A.

3. Gross Income and Principles of Section 61

Proposal

We recommend that Treasury and the Service publish guidance on the extent to which the "principles of section 61" (i.e., meaning U.S. tax principles) do not apply to the questions of entity characterization or income characterization.

Discussion

The Notice looks in general to foreign law to determine whether a foreign corporation's taxable income excludes in whole or in part nonresidence source income and whether such excluded income exceeds 20 percent of the gross income (again determined in general under foreign law) of the foreign corporation.

There are a number of issues raised by this test.

First, it is not clear how this test is applied where in addition to nonresidence source income the foreign corporation's country of residence also excludes same-country source income (e.g., intercompany dividends or dividends from entities incorporated in the same jurisdiction as the entity being tested). For example, assume a French parent holding company derives 85 percent of its income as dividends from a French operating subsidiary and 15 percent of its income from a non-French subsidiary that is not subject to a comprehensive foreign income tax. Assume the dividend income from the French subsidiary is excluded from income under French domestic law as is the non-French subsidiary income. The French holding company would

appear to constitute a nonqualified entity, because for purposes of the 20 percent test, the gross income denominator would only include the non-French subsidiary income.[173]

To avoid this result, we propose that gross income be defined as gross income as determined under the income tax laws of the foreign corporation's country of residence taking into account any same country source income that is excluded from gross income to the extent such excluded income is subject to at least one level of tax in the foreign corporation's country of residence. We acknowledge, however, that such rule may lead to tracking issues (i.e., one would need to determine how much of such income was actually subject to tax in the hands of some other taxpayer) and expense allocation issues.[174] Alternatively, the adverse outcome in the foregoing example may be avoided through the application of a group aggregation rule. See discussion in Part II.B.6.

Second, it would appear that because gross income is determined under foreign law, the fact that for U.S. tax purposes a subsidiary is disregarded or fiscally transparent should not be taken into account. However, the definition of gross income also includes "all nonresidence source income to the extent not otherwise taken into account." The term "nonresidence source income" is defined as any item of income that would be included in gross income, determined under the principles of Section 61, from sources outside the foreign corporation's country of residence, including dividends distributed by corporations that are not residents of the foreign corporation's country of residence. Because nonresidence source income is determined under the principles of Section 61, it is unclear whether the U.S. tax classification of the subsidiaries is relevant. As discussed above, the Notice generally looks to the classification of entities for U.S. tax purposes. If the parent corporation is treated for these purposes as directly earning all of the gross income of the disregarded entities, even if the entities paid all of their net income in dividends to the parent, and such dividends were included in the parent's taxable income under the tax laws of the parent's jurisdiction, the parent would have "excluded nonresidence source income" equal to the excess of the hybrids' gross income over their net income. This is surely an absurd result.

We believe that the Notice's reference to Section 61 principles was intended solely to add items such as excluded foreign dividends back into the numerator and denominator in determining the percentage of income subject to a comprehensive foreign income tax, and was not intended to import U.S. tax principles more generally. As a result, we recommend that Treasury and the Service clarify that the U.S. tax classification of entities in which a foreign

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[173] Note, however, that under the recommendations made herein, the result could be avoided if the taxpayer would elect the application of the group aggregation rules (i.e., so as to treat the parent company and its subsidiaries as a single plan sponsor) or if the parent and the French subsidiary form a consolidated group under foreign law (see Part III.I, which suggests that foreign principles, including foreign consolidation rules, should be taken into account in determining plan sponsor status).

[174] Assume in the foregoing example, that the French subsidiary earns 100 of gross income subject to tax, 20 of dividends excluded from tax and 90 of expenses (net income of 30, net taxable income of 10). When it pays a dividend of 20 to the French parent that is excluded from income, does the 20 consist (i) entirely of good income (because all same country exclusions are added back in), (ii) 10 of good income and 10 of bad income (because good income subject to tax treated as paid out first), (iii) 5/6 times 20 of good income (treating the dividend as paid proportionately out of income subject to tax and income not subject to tax), or (iv) 20 of bad income (because income not subject to tax income is treated as paid out first)?

parent corporation holds an interest is irrelevant for purposes of determining such parent corporation's gross income. This could be done simply by clarifying that the "principles of Section 61" should be applied as if all entities' classification for U.S. tax purposes matched their classification for the foreign parent's country of residence purposes.

Beyond the issues related to entity characterization, a requirement that foreign corporate plan sponsors literally apply all aspects of Section 61 and actually calculate what their worldwide gross income would be for U.S. tax purposes, as if they were U.S. taxpayers, would be an enormous compliance burden that in many cases would be prohibitively expensive. The consequences for service providers of their plan sponsor's inability or unwillingness to determine whether or not it is nonqualified are unclear, particularly where the plan sponsor is in fact not a nonqualified entity. This is all the more reason to apply primarily foreign tax principles, as the foreign corporation will have calculated their gross income in order to file tax returns in their jurisdiction of residence. That amount should then be modified solely to add back in the excluded nonresidence source income, and the nonresidence source income that would have been treated as excluded had it not fallen within a specified exception.

Because it is difficult to comprehensively determine the ways in which U.S. income inclusion principles would differ from foreign principles, we suggest that any use of Section 61 principles should be narrowly and precisely prescribed so as to avoid uncertainty. Guidance should clarify that the reference to Section 61 principles is not intended to treat as income an item for which there is simply a base/timing difference between U.S. and the relevant foreign law.[175] This would include, for example, differences in the accrual of income (e.g., OID principles and deemed dividends under Section 305, treatment of installment sales), computation of tax basis, realization principles, or the treatment of a hybrid instrument. Similarly, one should not be required to treat as excluded nonresidence source income the amount of any deemed income that is recognized for U.S. income tax purposes but not foreign law purposes (e.g., Section 78 gross-up, dual consolidated loss recapture, income included under Section 482 principles).

4. Exceptions to Excluded Nonresidence Source Income

Proposal

We recommend that the list of exceptions to excluded nonresidence source income be expanded to include:

- income of a permanent establishment in a third country that is subject to a comprehensive foreign income tax but is excluded from tax in the country of residence of the owner of the permanent establishment pursuant to an exemption regime;

- income of a permanent establishment in a third country that would expressly qualify for treaty benefits under the rule for "triangular cases;"

175 *Cf.* Treasury regulations Section 1.904-6(a)(iv).

- income from an investment in a partnership that is subject to a comprehensive foreign income tax but is excluded from tax in the country of residence of the investor pursuant to an exemption regime;
- gains from the disposition of stock in a corporation substantially all of the income of which is subject to a comprehensive foreign income tax;[176] and
- amounts treated under foreign tax law similarly to the U.S. tax treatment of "previously taxed income" (PTI).

Discussion

We propose not treating as excluded nonresidence source income any income that would expressly qualify for treaty benefits under the limitation on benefits provision for so-called "triangular cases." Income of a permanent establishment in a third jurisdiction raises similar problems in the treaty context as it does in the Section 457A context. Since Section 457A uses treaty eligibility as a way to determine whether an entity is subject to a comprehensive income tax, it is particularly appropriate to consider how the U.S. has dealt with triangular cases in its tax treaties. The U.S. does not want the exclusion from U.S. withholding taxes under a treaty between the U.S. and Country X to apply to income paid to a Country X resident's permanent establishment in a third jurisdiction if Country X does not tax such income, either. For this reason, most tax treaties between the U.S. and countries that have exemption systems rather than foreign tax credits contain a LOB provision specifying that certain income received by permanent establishments in third jurisdictions will not qualify for treaty benefits.[177]

However, these provisions typically contain exceptions that expressly extend treaty benefits to income of a permanent establishment in a third jurisdiction if either: (i) the combined tax imposed by the country of residence and the third jurisdiction is 60 percent or more of the tax the country of residence would have imposed had the income not been attributable to the permanent establishment, or (ii) the income is derived in connection with or incidental to the active conduct of a trade or business carried on by the permanent establishment in the third jurisdiction (other than the business of making or managing investments unless such activities are banking or insurance activities carried on by a bank or insurance company). Certain treaties also extend treaty benefits to income of a permanent establishment in a third jurisdiction if the permanent establishment is taxed by the U.S. or the country of residence under certain anti-deferral rules, such as the U.S.'s subpart F rules, or France's Article 209B.[178] As the LOB

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[176] It is not clear that such income would be treated as "nonresidence" income in the first instance. If it is so treated, and not excluded under the rule suggested in the text, an alternative would be to limit the exception to dispositions of non-portfolio positions (e.g., stock in foreign corporations in which 10 percent or more of voting power or value is held).

[177] *See*, e.g., the U.S.'s income tax treaties with France, Austria, Belgium, and Luxembourg.

[178] The U.S. may also apply this rule to treaties that do not specifically discuss it. *See*, e.g., the Treasury's Technical Explanation of the U.S. - Luxembourg treaty (Sept. 19, 1996): "Paragraph 7 also provides the competent authority with authority to unilaterally address so-called "triangular" cases arising under paragraph 5. An example where U.S. competent authority would grant relief would include triangular structures under which U.S.-source income subject to the provision is ultimately included in a U.S. shareholder's income under the provisions of [Subpart F] of the Code. In such a case, it is anticipated that

provisions applicable to triangular cases reflect careful policy decisions, and Section 457A specifically incorporates treaty eligibility into the nonqualified entity determination, we believe these exceptions to the treaty eligibility exclusion should be adopted as exceptions to the definition of excluded nonresidence source income.

As to the point regarding PTI, the Notice currently addresses the inclusion of income pursuant to an anti-deferral regime solely in the context of determining whether an eligible person is subject to a comprehensive foreign income tax in determining the nonqualified entity status of a partnership.[179] The Notice requires that an eligible person take the partnership income into account on a current basis under the income tax laws of the country in which the foreign person is resident. Inclusion in income under an anti-deferral regime does not count for these purposes. There is no comparable "current income inclusion requirement" under the nonqualified entity test for foreign corporations. Consequently, when such income is actually distributed to a foreign corporation and excluded from income under foreign law provisions comparable to the U.S. PTI rules, such exclusion should not count adversely towards the 20 percent test. Similarly, in the context of the partnership/eligible person test, because the inclusion pursuant to an anti-deferral regime is ignored, the exclusion of such income under foreign law provisions comparable to the U.S. PTI rules should not count adversely towards the "eligible person" test (otherwise this works as a double penalty).

Guidance should also clarify that in determining whether income of a partnership allocated to a non-U.S. person is treated as subject to a comprehensive foreign income tax, the list of items of nonresidence source income that are not treated as excluded for purposes of the 20 percent exclusion test applies. Q&A-11(f) of the Notice cross-references Q&A-8(a)(i)-(ii), whereas the list of "good income" items is contained in Notice Q&A-8(c)(iv). We believe that this is an oversight.

F. Alternative Standards for the "Substantially All" Test

Proposal

We recommend that Treasury and the Service treat the 80 percent "substantially all" test provided for in the Notice solely as a safe harbor. Treasury and the Service should create an alternative qualitative test that would permit a taxpayer to establish the substantially all requirement based on the application of various factors. Such factors could include, among others, (i) looking to the taxation of a plan sponsor's operating income rather than its exempt investment income in a situation where the plan sponsor does not have a significant amount of investment income, (ii) allowing for the application of the substantially all test by averaging income over a multiple year period, or permitting a grace period for plan sponsors that generally are qualified entities; or (iii) excluding certain exempt income from the determination in a particular year if such income relates to an extraordinary transaction or unexpected event.

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relief from U.S. tax under paragraph 5 would be granted to the extent the income is recognized under Subpart F."

[179] *See* Notice Q&A-11(f)(i).

Discussion

The statute does not define the meaning of "substantially all," nor does the legislative history provide any guidance as to what percentage threshold Congress had in mind. Presumably "substantially all" was thought to be something greater than 50 percent. The Notice's approach of reading "substantially all" to mean at least 80 percent is consistent with the interpretation of such term in other areas of the Code, and we agree that having a bright-line test provides valuable clarity to the application of the nonqualified entity determination.[180]

We believe, however, that this same clarity can be achieved by making the 80 percent test a safe harbor, and also permitting an entity that is generally subject to a comprehensive income tax regime based on alternative factors to be treated as not a nonqualified entity. The statute certainly does not preclude Treasury and the Service from providing taxpayers with the ability to meet the substantially all test based on an alternative testing approach. As explained above, the statute does not require residence in the taxing jurisdiction, and does not require substantially all of the corporation's income be subject to tax in any one jurisdiction.[181] Moreover, the legislative history indicates the nonqualified entity definition was intended to pick out those situations where the ordinary tension between the service provider (who is presumed to prefer deferral of tax) and the service recipient (who is presumed to prefer acceleration of deductions) does not exist. Given that the 80 percent test may not be met by many foreign corporations that are in fact not tax-indifferent, and that genuinely do seek to accelerate their deductions as much as possible, Treasury and the Service should provide that the 80 percent test provided for in the Notice is not absolute, but rather a safe harbor.

The need for one or more alternative qualitative tests is partially driven by the complexity of the nonqualified entity determination and the differences in the treatment of entities under foreign and U.S. law and various particularities of foreign tax regimes. It will be especially important to adopt an alternative, more flexible test, if Treasury and the Service do not adopt our proposal set fort in Part A.1 that one should look to foreign law principles (rather than U.S. law principles) in identifying the relevant plan sponsor. As illustrated by the examples in the Annex, looking to U.S. principles may lead to arbitrary results if the 80 percent test as set forth in the Notice is the only method for determining nonqualified entity status.

Plan sponsors that would otherwise generally qualify for the safe harbor may have "unusual years." That is, they may undergo reorganizations, incur in a particular year substantial amounts of exempt income as a result of dispositions of assets or investments that may give rise to exempt income under foreign law or receive in a particular year an unusually large distribution from a nonqualified entity. Plan sponsors otherwise subject to a comprehensive foreign income tax on their operating income may be residents in jurisdictions whose tax systems may provide for exemptions from tax for certain types of non-operating income. The relative size of these two types of income may vary from year to year. Flexibility for dealing with atypical years is especially important if Treasury and the Service continue to require recurring testing. However,

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[180] For example in ruling guidelines in the context of tax-free reorganizations under Section 368, "substantially all" has been interpreted to mean 90 percent of an entity's net income and 70 percent of gross income. *See* Rev. Proc. 77-37, 1977-2 C.B. 586.

[181] *See* footnote 169 above.

such flexibility would also be useful under the single testing date rules we have recommended above.[182] For example, new corporations (or existing corporations branching out into new markets or lines of business) may not yet have taxable operating income at the time they enter into new employee compensation commitments.

Allowing a taxpayer that does not meet a safe harbor to qualify under an alternative, more fact specific test is not new to the Code and regulations. For example, a public charity must generally establish that it receives a "substantial part" (generally, one-third) of its support from a governmental unit or from direct or indirect support from the general public in a particular year.[183] Alternatively, if an organization fails to meet the one-third support test, it can apply a more flexible, fact specific test and still qualify for exemption.[184]

There are obviously numerous ways that a qualitative test could be drafted. However, in coming up with the relevant factors, Treasury and the Service should consider the reasons a foreign corporation that is generally not tax-indifferent might either fail the 80 percent test or be unable to determine whether it met the 80 percent test or not (e.g., if it could not discern from its ordinary books and records the information needed to apply such test, could not determine the appropriate legal standards for applying the test, or could not obtain the necessary information about the tax positions of the companies from which it received dividends). If the 80 percent test would have been met but for atypical amounts or sources of income, alternative tests might look to establish that the entity would meet the 80 percent test in a "normal" or "average" year. If the problem stemmed from legal and/or factual uncertainties, alternative tests might look towards analysis of the books and records kept in the ordinary course of business, or the positions taken for tax purposes in the jurisdiction(s) in which the plan sponsor files returns.

In light of the foregoing, we propose that the following alternative tests, based on objective factors, might be made available (although others are certainly possible and would be welcome):[185]

One test could allow a plan sponsor that generally is an operating entity to look to the taxation of its *operating* income in a particular year, or the average taxation of its operating income over a multi-year period (e.g., whether at least 80 percent of the operating income is ECI and/or is subject to a comprehensive foreign income tax), without regard to the taxation of its investment income (e.g., dividends, interest and capital gains). We propose that this alternative should apply only to operating companies. Although there was a broad consensus that a broader rule was appropriate for operating companies, the Tax Section's Executive Committee did not

[182] *See* discussion in Part II.G.1 above.

[183] *See* in general Treasury regulations Section 1.170A-9T(f).

[184] Under the alternative test, a charity will be treated as publicly supported if (i) it normally receives a "substantial part" of its support (i.e., at least 10 percent) from eligible public sources and (ii) is organized and operated in the nature of an organization that is publicly supported (determined based on certain facts and circumstances).

[185] Treasury and the Service could treat a foreign corporation as not nonqualified to the extent it meets any one alternative test, or could require that at least two alternative tests be met. In any event, we believe that different tests will be suited to different situations, and that no corporation should be required to meet all the tests suggested here.

come to a judgment as to how to define "operating company" for this purpose. One relatively easy test (and one that many entities already have to determine for purposes of tax disclosures) would be to exclude from this alternative test corporations that are PFICs, or partnerships or other entities that would be PFICs if they were classified as a corporation. Some Committee members believe, however, that PFIC status may be too easy to avoid through structuring and that another test might be more appropriate (e.g., under the Investment Company Act or looking to "qualifying income" for purposes of Section 7704). There will need to be a regulatory definition of "investment fund" for purposes of the Section 457A "investment asset" exception, and it is possible that an operating company could be defined as an entity that is *not* an investment fund.

We believe that a broader rule for operating companies is warranted because they were (at least anecdotally) not the main focus of the legislation, they will tend to have more complicated computations of income and deduction than investment companies, and they will often have more complicated compensation arrangements with their employees and other service providers. We believe this is consistent with the statutory purposes of Section 457A, in that operating companies that generally are subject to tax on their operating income, and for which operating income is not a small portion of their overall income, are not tax-indifferent. Moreover, this would avoid "inadvertent" nonqualified entity status for entities that generally pay substantial tax but may have variable and unpredictable amounts of exempt investment income. We note that this alternative would be extremely unlikely to apply to any hedge fund or similar asset management company.

A second test would be merely to test whether the income of a plan sponsor is, on average, subject to a comprehensive foreign income tax over a multiple year period, e.g., that excluded nonresidence source income does not exceed 20 percent on average over three years, even though it may have excluded nonresidence source income that exceeds 20 percent in any specific year. This would avoid situations in which variations above and below the 80 percent threshold occur in an entity that generally does not have substantial excluded nonresidence income. A similar alternative would allow an entity that was *not* a nonqualified entity for two years (or three out of the prior five years, or some similar test) to have a single "bad" year not counted as a year in which it was a nonqualified entity (i.e., a grace period).

A third test could allow income recognized as a result of transactions outside the ordinary course of business (i.e., dispositions, liquidations of subsidiaries, extraordinary dividends etc.) to be entirely disregarded, or disregarded up to a certain "cushion" amount, in a given year.[186] The rationale for this sort of test is that to the extent Section 457A is focused on entities that generally are tax-indifferent, changes in income composition out of the ordinary course of business ought not to be relevant.

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[186] *See* for a similar rule in Treasury regulations Section 1.509(a)-3T(c)(3), which permits unusual grants received by a publicly supported organization to be excluded from the numerator and denominator of the one third public support fraction if, among others, taking such grant into account would adversely affect the organization as otherwise meeting the relevant support test.

G. Materially More Favorable Tax Regimes

In order for a foreign corporation to be treated as subject to a comprehensive foreign income tax, the foreign corporation cannot be taxed by the foreign corporation's country of residence under any "materially more favorable regime than the corporate income tax otherwise generally imposed by such country."[187] This requirement is not in the statute, but was introduced by the Notice.[188]

1. Categorizing Special Tax Regimes

Proposal

Guidance should provide that only entities generally subject to special regimes, rather than enjoying certain specific exemptions (other than income tax holidays or income tax breaks to the extent that these are separately negotiated, rather than generally applicable incentives), are covered by this provision.

Discussion

We assume that this test is intended to cover instances where certain taxpayers are subject to lower tax rates compared to other taxpayers. For example, we presume that this provision is applicable to collective investment vehicles or foreign law equivalents of REITs or RICs or more generally, entities that are entitled to dividend-equivalent deductions in respect of their distribution of earnings.[189] Included in such group should also be Irish Section 110 Companies and foreign securitization vehicles (e.g., Luxembourg SICAVs) that are subject to taxation regimes that allow the payment out of all or substantially all of their income in the form of deductible expenses. We do not believe that a general exclusion of certain types of income (e.g., cancellation of debt income), loss sharing arrangements (e.g., consolidation, or mandatory or optional loss sharing or loss surrender), carry-forward or carry-back rules, or tax incentives, such

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187 *See* Notice Q&A-8(a)(ii).

188 Neither the H.R. 6049 JCT Explanation, nor the H.R. 7060 JCT Explanation includes any specific discussions regarding the impact of preferential tax regimes on the application of Section 457A. The H.R. 7060 JCT Explanation solely addresses jurisdictions with territorial tax regimes and provides that guidance may be issued regarding the application of the "comprehensive foreign income tax" requirement to corporations that are residents in countries that have such regimes.

The Blue Book, however, which was issued after the Notice, provides that "[C]ongress further does not intend to permit a taxpayer to avoid the application of the provision by availing itself of a legal entity that is considered resident in a country with which the United States has an income tax treaty but that pays little or no tax in that country because of a preferential regime that is available to certain types of qualified or special purpose entities (such as financial companies or holding companies) or specified income (such as investment income) or that provides liberal profit extraction rules. Accordingly, it is expected that the Secretary will provide guidance addressing the question of whether, or in which circumstances, a corporation is a nonqualified entity because it is subject to a preferential tax regime in its country of residence."

189 Some jurisdictions provide preferential tax regimes for investment income, for example in form of exemptions from tax or reduced rates of taxation. These types of regimes generally would be covered as "special regimes" for investment vehicles, and/or would be substantively covered by the 20-percent excluded income test.

as accelerated depreciation deductions, inventory accounting methods, or R&D tax credits, or deductions or credits otherwise generated under the normal income tax principles of the foreign jurisdiction, constitute a "materially more favorable regime or arrangement." The foregoing exclusions or special incentives are of a type that would generally also be available for U.S. corporations, which we believe may be a helpful benchmark in defining the scope of covered provisions.[190] The Service should clarify this by providing examples.

Also, specific types of taxpayers subject to special tax regimes should not be treated as subject to a "materially more favorable regime," where such regime is imposed instead of the otherwise generally applicable income tax regime. For example, if a mining company is taxed based on production and not under the corporate income tax regime otherwise generally imposed, and under certain conditions the production tax imposed may be higher than the corporate income tax would have been, the mining company should not be a nonqualified entity even if under the facts the production tax happens to require payment of less tax than the normal income tax would have. Consistent with the foregoing, a solution may be to distinguish between benefits accorded under the general tax system and special regimes by imposing a test analogous to the "in lieu of an income tax" for foreign tax credit purposes. Under the foreign tax credit rules, a foreign tax that is not an income tax may still be creditable if it is a tax paid in lieu of a tax on income otherwise generally imposed by a foreign country. Thus, as long as the incentive is in lieu of benefits generally available under the general income tax system, it should not constitute a materially more favorable regime.

It is not clear whether the "materially more favorable regime" rule is also targeted at taxpayers that enjoy tax holidays or tax breaks. We believe that income tax holidays (e.g., exemption from tax during a start-up period) or income tax breaks (e.g., reduced tax rate for a certain period of time) should be considered a "materially more favorable regime," while non-income tax breaks or tax holidays (e.g., exemption from property tax or sales taxes) should be of no relevance. Alternatively, we believe that a reasonable rule might consider whether income tax holidays or income tax breaks should only constitute a "materially more favorable regime" to the extent these are specially negotiated deals. Accordingly, if such tax incentives are available in a jurisdiction to all taxpayers (e.g., a jurisdiction provides an exemption from or reduction of tax to all start-ups), such incentives should be considered features of the generally applicable tax system, and not "materially more favorable regimes." We acknowledge, however, that the differentiation may be difficult where such incentives are generally available (as opposed to separately negotiated), but are limited to certain industries or certain geographic locations.

2. Portion of Income Subject to Favorable Regime

Proposal

If only a portion of a plan sponsor's income is subject to a materially more favorable regime, the plan sponsor should not be treated as nonqualified, as long as not more than 20 percent of its gross income is subject to such regime.

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[190] We do not suggest, however, that only exemptions that are available under U.S. law to U.S. corporations be treated as not constituting a materially more favorable regime.

Discussion

There may be circumstances where only a portion of a plan sponsor's income is subject to a materially more favorable regime. This can be the case where two or more entities are aggregated under the group aggregation rules or where entities are consolidated for foreign law purposes (and based on our recommendation) treated as a single plan sponsor and where one of the entities is subject to a materially more favorable tax regime. Alternatively, this may be the case where a plan sponsor has a subsidiary that is subject to a materially more favorable regime and where the subsidiary is treated as a disregarded entity for U.S. tax purposes. If contrary to our suggestions set forth in Part III.E.2, the U.S. tax classification of an entity prevails, a portion of the parent's income would be treated as subject to a materially more favorable tax regime. In these circumstances, the Notice would seem to disqualify the plan sponsor as a nonqualified entity, even if only as little as one percent of the aggregated gross income is subject to a materially more favorable tax regime. This all or nothing approach does not seem justified. We recommend a rule that clarifies that if not more than 20 percent of a plan sponsor's gross income is subject to a materially more favorable regime, the plan sponsor should not be treated as a nonqualified entity under Section 457A solely as a result of the "materially more favorable regime" test. We assume that the idea behind the requirement that the plan sponsor not be subject to a special tax regime that is more favorable than a country's regular tax regime, is that there is a concern that the plan sponsor's income be subject to a regular level of tax. This is comparable to the concern that not more than a certain minimum amount of income not be excluded from tax in the corporation's country of residence. Consequently, it would seem unjustified to treat a plan sponsor as a nonqualified entity if only a portion of its income is subject to a special regime, as long as such income does not exceed a certain threshold. We propose the adoption of a 20 percent test consistent with the 20 percent excluded income test imposed under Notice Q&A-8(b)(ii).

3. Non-Corporate Entities

Proposal

Guidance should also provide how the materially more favorable tax regime test is intended to apply to persons or entities not subject to a corporate tax regime but rather an individual tax or partnership tax regime.

Discussion

When this test is applied to non-corporate entities, under Notice Q&A-11(f)(ii)(A), would taxation under a regime that was more favorable than the general corporate income tax *per se* prevent such non-corporate entity from qualifying as subject to a comprehensive foreign income tax? Or would this "materially more favorable regime" test be applied to non-corporate entities only by analogy? Note that Notice Q&A-11(f)(ii)(A) requires that the non-corporate entity be treated as a "foreign corporation" when applying this requirement. It is not clear how this rule is intended to work. Guidance is needed in this respect.

H. Compliance and Reporting Issues for Foreign Corporations

As can be seen from the discussion above, the determination of whether a foreign corporation meets the tax treaty or tax system test raises significant compliance and documentation concerns for service providers. Neither the statute nor the Notice currently provide any guidance in this respect.

1. Annual Reporting Requirements

Proposal

As discussed in Part II.A we expect (and propose) that the determination of nonqualified entity status will be in fact made by the service recipient and reported to the service provider on an annual basis. Specifically, we suggest that foreign corporations with U.S. tax return filing obligations or with obligations to withhold and pay employment taxes in the United States on behalf of U.S. employees be required to provide its service providers within a certain amount of time after the end of the corporation's taxable year (e.g., 90 days) with its good-faith reasonable determination as to whether or not the foreign corporation is a nonqualified entity for that taxable year or, alternatively, whether the nonqualified deferred compensation, if paid in cash on the date that it is no longer subject to a substantial risk of forfeiture, were deductible against the foreign corporation's ECI.[191] As discussed in Part II.A we recommend that certain service providers (i.e., "lower-tier" and "middle-tier" — that is service providers without influence over the analysis or independent access to relevant facts) should be entitled to rely on such statement, without being subject to audit.

Discussion

Service providers are subject to Section 457A (including interest and penalties) regardless of whether or not they are in a managerial or influential position, or have any access to the information needed to evaluate the plan sponsor's status. For that reason, in Part II.A we propose imposing reporting requirements on the plan sponsor. However, these requirements will only ameliorate the predicament of service providers who lack access to the plan sponsor's books and records (or to the books and records of the plan sponsor's subsidiaries) if the service provider is allowed to rely on the information the plan sponsor provides.

We therefore recommend that a service provider should generally be able to rely on the service recipient's certification, without being subject to an audit. However, the reliance should not apply to situations when the service providers (i) have managerial authority, (ii) are personally and materially involved in performing the analysis of the plan sponsor's status, (iii) are significant direct or indirect owners of the plan sponsor, or (iv) are key employees.

[191] Section 457A(d)(4).

2. Retroactive Redeterminations

Proposal

In the event that the foreign corporation is later determined to have been a nonqualified entity (e.g., as a result of adjustments to its income pursuant to an audit, failure to qualify for treaty benefits, etc.) or where the identity of the plan sponsor retroactively changes as a result of a reallocation of the compensation expense to an affiliated entity, the service provider should not be subject to interest or penalties for the period prior to the taxable year of the redetermination (in the case of "higher-tier" service providers) or should not be subject to Section 457A altogether (in the case of "lower-tier" and "middle-tier" service providers).

Discussion

The determination of nonqualified entity status is a complex process and requires not only a proper assessment of the relevant facts but also numerous legal conclusions, including under non-U.S. tax laws. Assuming that a plan sponsor has enough time to correctly analyze its nonqualified entity status for a given taxable year before its service providers are required to file their tax returns for the same (or overlapping) taxable year, the plan sponsor's analysis will be based on its filings with various tax authorities. The plan sponsor's tax position is subject to audit by these authorities. On audit, the plan sponsor's gross income may be adjusted, or simply reallocated amongst its branches or other affiliates. For example, U.S. or foreign tax authorities may successfully challenge the transfer pricing methodology used by the plan sponsor. Subsequent changes in transfer pricing analysis can not only alter an entity's status, but can retroactively shift the allocation of compensation expense for certain service providers to another entity, thereby changing the identity of the plan sponsor. (For example, Xilinx[192] had a portion of its employee compensation retroactively allocated to foreign affiliates in a qualified cost sharing arrangement.)

In many instances, the redetermination may not occur till many years later (e.g., where the compensation expense gave rise to a net operating loss that was carried forward for several years) and the service provider may no longer be employed by the service recipient at the time of the redetermination. Having Section 457A apply retroactively to a service provider who had relied in good faith on the information provided by its employer seems an unfair outcome.

We recommend that a service provider, even one with influence over the service recipient ("higher-tier" service providers), should be exempt from the application of interest and penalties if as a result of these retroactive redeterminations the plan sponsor is considered a nonqualified entity, or expense that had been treated as deductible against effectively connected income no longer is so treated. It would be reasonable for this rule to apply only where the initial position had substantial authority, if the service provider was able to influence the tax position taken. Service providers with less influence over the service recipient should be entitled to rely on the initial determination that the service recipient was not a nonqualified entity. This suggested safe harbor also eliminates the practical compliance problems that would arise with any retroactive change in plan sponsor status or the allocation of deductible expense (and the fact that the

[192] *Xilinx Inc. et al. v. Commissioner*; Nos. 06-74246, 06-74269 (9th Circuit, May 27, 2009).

nonqualified entity status of an employer may implicitly become a bargaining chip for IRS agents on audit). The change may occur many years later, and some service providers may no longer be employed by the entity.

3. Good Faith Standard

Proposal

Service providers (other than "higher-tier" service providers) receiving compensation from foreign corporations that cannot be subjected to these reporting requirements should not be subject to interest and penalties if they have made a good faith effort to obtain the requisite information through a written request, where it is later determined that the foreign corporation in fact was a nonqualified entity or where they never received sufficient information to come to a final conclusion as to the nonqualified entity status of the plan sponsor.

Discussion

In the context of foreign corporations, compliance issues are exacerbated by the fact that foreign corporations (unless they are subject to U.S. tax return filing requirements) cannot generally be subjected to any reporting obligations. If such foreign corporate plan sponsors are subsidiaries of a U.S. headquartered multinational or employ a large number of U.S. citizens, one may expect that such foreign corporations will voluntarily comply with any reporting requirements. However, it is unclear how, for example, a PRC company with no U.S. operations that employs a few U.S. citizens can be subjected to any reporting rules and what effect (if any) the failure to provide the service providers with the required information would have on them. A good faith effort ought to be sufficient to protect service providers (other than "higher-tier" service providers) from Section 457A's punitive consequences. Section 457A would also still clearly apply in the most egregious cases, such as corporations organized and operating in tax havens.

I. Controlled Group Aggregation Rules

The Notice does not clarify whether the Section 414(b) and (c) aggregation rules apply in the context of the determination of plan sponsor status. The statute specifies that "similar" rules would apply, but the JCT undermines this by saying the "determination of a particular entity's nonqualified entity status under the provision is generally performed on an entity-by-entity basis."[193] The Blue Book characterizes the intent of the statute's reference to the aggregation rules as "that the Secretary may permit or require (as appropriate under the circumstances) that the determination of nonqualified entity status be performed on an aggregated basis, for example, in the case of an aggregated group of entities that are organized in the same jurisdiction."[194]

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193 Blue Book at 534. The Blue Book also notes that a technical correction may be necessary so that the statute reflects the intent not to treat every entity within an aggregated group as a nonqualified entity merely because one entity in the group is a nonqualified entity.

194 *Id.*

Proposal

We recommend that guidance clarify that mandatory aggregation rules should not apply at all, unless an entity is part of a consolidated or combined group under foreign law. We further recommend that plan sponsors may optionally elect into an aggregation regime, either on a same-country basis or worldwide basis.

Discussion

We do not believe that the same aggregation rules provided for under Section 409A should apply at all in light of the fact that Section 457A is targeted at deferred compensation arrangements of specific types of service recipients (i.e., tax-indifferent entities), while Section 409A applies to any type of service recipient.

If the Service and Treasury adopt our proposal that the term "plan sponsor" be defined based on the entity that is entitled to a compensation deduction under foreign tax law, the only relevant aggregation should be based on the treatment of the plan sponsor's affiliates under such foreign tax law. For example, if the plan sponsor controls a hybrid entity that is treated as a subsidiary for U.S. tax purposes but treated as a branch under the laws of the plan sponsor's country of residence, the income of such hybrid entity should be considered part of the gross income of the plan sponsor, because, in general, the compensation deduction would have been deductible against such income. This is especially appropriate when the subsidiary, and not the parent, would have been entitled to the compensation deduction under U.S. principles, and the only reason the parent and not the subsidiary is treated as the plan sponsor is because the parent would have been entitled to the compensation deduction under applicable foreign laws.

Similarly, we believe that the application of a mandatory aggregation rule would be appropriate where entities are part of a combined or consolidated group under foreign law, since under foreign law it is the aggregated group of entities that would be subject to tax on income and have the benefit, or not, of a deduction of compensation.[195]

We do not believe that a mandatory worldwide (or even same-country) aggregation rule is appropriate, however. The determinations to be made under Section 457A are generally computed on an entity-by-entity basis, and it is not readily apparent why an entity that in fact pays tax on all of its income should be treated as a nonqualified entity merely because certain of its affiliates do not pay tax.

Notwithstanding the fact that we do not recommend a mandatory aggregation rule, with the exception of a foreign consolidated or combined group, we do recommend permitting a service recipient to elect into aggregation with its controlled group affiliates, either on a same-country basis or on a worldwide basis. This would potentially ease some of the administrative burdens of determining nonqualified entity status for foreign groups of corporations (e.g., if there are substantial intra-company transactions) and avoid difficult apportionment issues (e.g., where

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[195] A private equity fund that owns interests in portfolio operating companies would generally not qualify for aggregation under this proposal because the fund is generally not formed in the same jurisdiction as the operating companies.

an employee is hired by a service company on behalf of an entire group). Since the helpfulness of this sort of aggregation will depend on the specific details of the relevant foreign groups, we believe that this aggregation should be elective (and made annually, since the relevant details for a group, in terms of the composition of its entities, the relevant foreign law, its employment arrangements etc. may change from year to year). We do not believe that this sort of elective aggregation will facilitate abusive arrangements;[196] to the contrary, where a controlled group in aggregate has substantially all of its income subject to a comprehensive foreign income tax, the group in general will not be indifferent as to the timing of compensation deductions. The suggestion that a same-country aggregation rule might be appropriate as well as a worldwide aggregation rule is primarily justified by potentially making the determinations under Section 457A consistent with "weak" forms of consolidation under foreign law (e.g., in form of a dividend exemption for same country subsidiaries). In the absence of such a rule, the computation of the percentage of excluded nonresidence source income may become skewed due to the exclusion of domestic source income from both the numerator and denominator of the 20 percent excluded income test fraction.

IV. Partnership Issues

A. Compliance and Reporting Issues

Background

The determination of whether an entity constitutes a "nonqualified entity" raises significant compliance and documentation concerns, none of which have been addressed in the statute or the Notice. Part II.A addresses general compliance and reporting issues (e.g., how service providers will be able to determine whether a service recipient is a nonqualified entity and what obligations service recipients should have in providing such information to service providers). Part III.H discusses the compliance implications for corporations in determining whether they constitute nonqualified entities — that is, whether they meet the tax treaty or tax system test. The following section focuses on the compliance and reporting issues raised by the rules of Q&A-11 of the Notice, which are applicable to service recipients that constitute partnerships for U.S. tax purposes.

We believe that the implications of the nonqualified entity analysis in the partnership area are significantly more complex than with respect to corporations. This is the case because the rules look to the allocation of items of gross income of the partnership in determining whether a partnership is a nonqualified entity and allow such items to be deemed allocated to any person at any tier of ownership (including for example, indirect partners), provided no item is counted more than once. This multi-tier approach is generally favorable, in that it focuses on the beneficial entitlement to the gross income allocations for purposes of making a nonqualified entity determination. However, it requires that a plan sponsor not only have information about the tax status of its direct partners, but also indirect partners, including a detailed understanding

[196] Aggregation will generally not be helpful for pass-through entities, like private equity funds, because the relevant test looks to whether the partnership's income is allocable to eligible persons. The fact that the partnership's income is an aggregate of the respective incomes of its portfolio companies does not change this requirement.

of the income allocation provisions of higher-tier partnerships (i.e., to the extent the partners of the plan sponsor are themselves partnerships). In addition, as in the context of foreign corporations that are direct or indirect partners, certain determinations are made by reference to foreign law and thus require an understanding and information about foreign tax consequences. For example, a determination is necessary as to whether a foreign partner takes the partnership income into account on a current basis (other than pursuant to an anti-deferral regime) under the income tax laws of the country in which it is a resident.[197]

The Notice specifies that "substantially all" of a partnership's income is allocated to eligible persons only if 80 percent of the gross income of the partnership for the taxable year is allocated to such persons. Gross income may be allocated to eligible persons at any tier of ownership, provided it is only counted once. Similarly, an item of gross income that is allocated to a trust or estate that is a U.S. person may be treated as allocated to a beneficiary of the trust or estate if the beneficiary takes such income into account on a current basis. The Notice even allows a partnership to "allocate" an item of gross income to itself, provided that the partnership (which would necessarily need to be a foreign resident partnership) is subject to a comprehensive foreign income tax with respect to such income.

Generally, eligible persons with respect to any income are those subject to tax on such income on a current basis.[198] This includes most U.S. persons (except for tax-exempt organizations, domestic partnerships, and certain trusts or estates). It also includes foreign persons with respect to effectively connected income subject to U.S. federal income tax.[199] Tax-exempt organizations are eligible persons with respect to unrelated trade or business income ("UBTI") subject to U.S. federal income tax under Section 511.[200]

If a foreign person is not subject to U.S. federal income tax with respect to its allocated partnership income, it is an eligible person with respect to such income only if it is "subject to a comprehensive income tax with respect to such income." Among other things, this requires that the foreign person be taxed on such income on a current basis by its country of residence. Income included currently "solely by reason of an anti-deferral regime" such as Subpart F, PFIC rules, or "comparable provisions of foreign law" is excluded from this category. In addition, a foreign person will be an eligible person with respect to an item of income only if (i) such foreign person is a nonresident alien individual or is an entity that is not fiscally transparent under the law of the entity's jurisdiction, (ii) such foreign person is eligible for the benefits of a

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197 *See* Notice Q&A-11(f)(i).

198 *See* generally Notice Q&A-11(e).

199 There may in certain circumstances be a question as to whether a foreign partner is subject to tax on particular income as effectively connected income because it will depend on the foreign person's status (e.g., eligibility for benefits under a tax treaty, or exemption from certain types of income under Section 892).

200 Given the wording of Q&A-11(e)(i), the Service should consider clarifying that income subject to tax as unrelated debt financed income under Section 514 is fully taken into account as UBTI under the principles of Treasury regulations Section 1.514(a)-1(a)(1) (or possibly that all debt financed income is treated as subject to tax, without requiring a computation of the percentage of acquisition indebtedness), and provide for tax-exempt partners to report the amount of such income to the partnership to the extent that the relevant debt-financing is not at the level of the partnership.

comprehensive income tax treaty with the United States, or demonstrates to the satisfaction of the Secretary that it is resident for tax purposes in a foreign country that has a comprehensive income tax,[201] (iii) such income is not taxed at a rate less than 50 percent of the generally applicable rate or otherwise excluded from its taxable income, such as excluded from gross income or deducted (including, for example, due to a dividends received deduction), and (iv) in the case of a foreign person that is not a nonresident alien individual, the entity is not taxed by its country of residence under any regime or arrangement that is materially more favorable than the corporate income tax otherwise generally imposed by such country.

Notably, under the Notice, gross income is not treated as allocated to an eligible person if it would otherwise be taxable to a foreign person as effectively connected income but is exempt from taxation pursuant to a U.S. treaty obligation *even if that income is otherwise subject to a comprehensive foreign income tax*.[202] Likewise, under the Notice, gross income described in Sections 871(a) and 881(a) (so-called "FDAP" income) is not treated as allocated to a foreign eligible person merely because such income is subject to withholding at source in the United States.[203]

While Section 457A and the Notice focus on the tax profile of the partnership plan sponsor and its beneficial owners (direct, and in certain circumstances, indirect), the statutory responsibility for determining the applicability of Section 457A and its consequences resides with the service provider. The complexity of the partnership rules described above raises the question of how a service provider will be able to obtain the relevant information to make such determination in time to file the requisite tax returns accurately, given that the information relevant to the determination of a plan sponsor's nonqualified entity status is in the hands of the service recipient and its direct or indirect beneficial owners (and may not be readily available to most service providers).[204] Even if, as we expect (and propose), the determination of nonqualified entity status must in fact be made by the service recipient and reported to the service provider, in light of the complexity set out above the service recipient partnership may itself lack sufficient information to make a determination.

Proposals

We strongly urge that future guidance address the compliance aspects in the context of determining whether "substantially all" of a partnership's gross income is allocable to eligible persons. We have four compliance recommendations:

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201 While the intent here may be easily understood, it is unclear why the Notice places the burden of demonstrating the comprehensiveness of their foreign income taxes on the indifferent foreign partners, when it is the service provider who will need to determine whether Section 457A is applicable.

202 *See* Notice Q&A-11(e)(ii). We believe that this is a glitch in the Notice that should be corrected.

203 *See* Notice Q&A-11(e)(iv).

204 The annual reporting of amounts deferred under a nonqualified deferred compensation plan under Section 409A by the service recipient (i.e., either on a W-2 or Form 1099) in the year of deferral has been suspended. *See* Notice 2008-115, 2008-52 I.R.B. 1367. In case of Section 457A, since a determination of nonqualified entity status will in practice need to be made on a yearly basis, we assume (and recommend in Part II.A of this Report) that there be an annual reporting requirement imposed on service providers that have nonqualified deferred compensation plans outstanding that could be subject to Section 457A.

- First, a partnership should be required to provide its service providers an annual determination of the partnership's nonqualified entity determination status, and service providers should generally be permitted to rely on such determination.

- Second, to ensure the reliability of a plan sponsor partnership's nonqualified entity determination, guidance should require that a plan sponsor partnership obtain information and maintain records necessary to substantiate the beneficial ownership of the partnership interests and the tax status of its partners.

- Third, in order to reduce the inevitable administrative burden imposed in connection with a required nonqualified entity determination, we believe that certain simplifying conventions should be available, limiting the information required from partners to the extent that the partnership is widely held or the partner owns a *de minimis* interest and generally permitting plan sponsor partnerships to make certain presumptions in connection therewith.

- Fourth, we believe a transition rule will be necessary pending implementation of the foregoing recommendations. We therefore suggest that for taxable years that begin prior to the time that further guidance is issued, a partnership should not be treated as a nonqualified entity unless a service provider has actual knowledge that more than 20 percent of the partnership's gross income will be allocated to persons other than eligible persons.

Discussion

1. Partnership Determination and Service Provider Reliance.

We believe that, in general, the determination by a partnership as to whether or not it is a nonqualified entity, and the ability of a service provider to rely on a statement regarding such determination (or make a good faith determination in the absence of such a statement), should be governed by rules similar to those described above in Parts II.A and III.H.

So that service providers may be able to determine the application of Section 457A, we believe that a U.S. partnership, or a foreign partnership with U.S. tax filing obligations, should be required to provide to its service providers within a period of time after the end of the partnership's taxable year (e.g., 90 days) a good-faith reasonable determination as to whether or not the partnership is a nonqualified entity for that taxable year.

Given the imbalance of information as between the service recipient partnership and the service provider, we believe that the same sort of three-tier division of service providers should apply.

- The "lower-tier" service providers should be excluded entirely from Section 457A.

- The "middle-tier" service providers should be entitled to rely on such a statement in the absence of actual knowledge that the statement is incorrect without the nonqualified entity status of the partnership being subject to audit.

- The "higher-tier" service providers should generally be subject to Section 457A. Because the determination of whether a partnership is a nonqualified entity will in many cases depend on the tax treatment of its partners, however, a service provider should be entitled to rely on partner statements or simplifying presumptions with respect to the tax status of a partner (as a "middle-tier" service provider would) except to the extent that the service provider would qualify as a "higher-tier" person with respect to that partner.

In the event that the partnership is later determined to have been a nonqualified entity (e.g., as a result of a reallocation of partnership income among partners, or an adjustment to the partnership's income), service providers that are "lower-tier" or "middle-tier" should not be subject to Section 457A. "Higher-tier" service providers should be subject to Section 457A, but not to interest or penalties for the period prior to the taxable year of the redetermination.

For service providers that provide services to non-U.S. partnerships (including "U.S. relevant" partnerships that generally allocate income pursuant to Section 704(b), but that do not have U.S. tax filing obligations), it is not clear how such service providers will obtain the necessary statement about the nonqualified entity status of the partnership. Similarly, service providers that provide services to U.S. partnerships may not receive the statement, even if one is required.[205] We believe that guidance should provide for an exception from penalties for service providers (other than "higher-tier" service providers) that have made a good-faith effort to obtain the requisite information through a written request, where it is later determined that the partnership in fact was a nonqualified entity.

2. Partnership Substantiation of Non-Qualified Entity Determination.

As is evident from the discussion above, a partnership will need to undergo a detailed annual analysis of the tax status of its partners, including their treatment under foreign law, in order to determine whether or not it constitutes a nonqualified entity.[206] There is currently no reporting regime that would require a partner to deliver the sort of information to a partnership that would enable the partnership to accurately make its determination.[207] Consequently,

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[205] As discussed further below, U.S. partnerships may be unable to obtain required information from direct and indirect partners, and thus may not know how to report their status.

[206] Where the partner is a foreign person and the partnership's income is treated as ECI, the partnership should generally not require any further information as it will have been required to withhold on such income under Section 1446 and thus should be able to make the relevant determination itself. Further analysis may still be necessary where the partnership has also income that is not ECI (e.g., dividends from U.S. or foreign subsidiaries).

[207] U.S. partnerships generally will have received forms W-8 and W-9s from their partners (and in the case of a pass-through foreign partner that has provided a Form W-8IMY, may have received Forms W-8 or W-9 from its owners), but generally will not have received any information regarding the owners of upper-tier entities, or have received information regarding the tax-exempt status of any U.S. partners (direct or

regulations should require that each partner of a domestic partnership (or foreign partnership with a U.S. tax filing obligation) that is the sponsor of a nonqualified deferred compensation plan be required to supply the information described above within a certain time period (e.g., 30 days) after the close of the partnership's taxable year.[208] We do not believe, however, that it is appropriate, or practical, to impose penalties on non-U.S. partners that fail to provide the requisite information, or on U.S. pass-through partners that are unable to provide complete information about their owners.

Given the potential administrative burden on partners and in some circumstances legal judgment required of the partners (particularly foreign and pass-through partners) in order to provide the relevant information, and the understandable reticence of partners to deliver this information where they derive no benefit from doing so, we suggest that the information to be provided should be short-form based on reasonable belief and not be provided under penalties of perjury. Many partners, and particularly foreign partners that need to determine whether they are subject to a "comprehensive foreign income tax," will likely not be comfortable with providing such information due to the current uncertainty as to the scope and meaning of various elements of the required analysis. We therefore strongly encourage the Service to develop a questionnaire or other appropriate forms with detailed instructions that could serve as a tool to guide taxpayers through the determination process. The information to be provided should include:

- the partner's tax status (foreign or U.S. person)[209] and beneficial ownership during the year;
- in the case of a trust or estate, whether the trust or estate is subject to U.S. federal income tax on its income and whether income so subject is neither included in the gross income of a beneficiary under Sections 652 or 662 or paid or permanently set aside for a charitable purpose within the meaning of Section 642(c);
- in the case of a tax exempt partner, the amount of income allocated to such partner during the year that was subject to tax as UBTI;[210]

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indirect). "U.S. relevant partnerships," even if foreign, may have received such forms from their partners, but they will not necessarily have done so.

208 We believe that providing for mandatory reporting rules with no penalties is preferable to rules relying on a service provider and a service recipient building the information reporting requirements into their respective agreements (e.g., employment contract; engagement letter), as "lower-tier" and "middle-tier" service providers may often not have the ability to require the service recipient to provide them with such information.

209 The partnership will generally have already obtained this information (in form of Forms W-9 and Forms W-8) in order to comply with the Section 1446 withholding requirements.

210 Section 6031(d) of the Code requires partnerships in their tax reporting to tax-exempt partners to separately state income or loss attributable to a "trade or business" (within the meaning of Section 512(c)(1)). This information, therefore, need not be provided by the partner to the partnership. However, income allocated to a tax-exempt partner and otherwise eligible for exemption may be subject to tax as UBTI due to, among other things, acquisition indebtedness incurred by the partner in connection with its investment in the partnership.

- in the case of a pass-through partner (e.g., a partnership, S corporation and trusts and estates not described above), the extent to which its beneficial owners are subject to tax on such income (without requiring the pass-through partner to identify such partners or describe its allocations);[211] and

- in case of a foreign partner, whether such partner was subject to comprehensive foreign income tax with respect to such income as laid out in Q&A-11(f) (see discussion under "Background" above).

3. **Simplifying Presumptions.**

We also believe that certain simplifying conventions should be available to limit the information required from partners to the extent that the partnership is widely held or the partner owns a *de minimis* interest. These presumption rules would apply to a partnership that is required to provide an annual statement to its service providers and to "higher-tier" service providers that are required to make an independent determination (e.g., if they are service providers of a non-U.S. relevant partnership that is not subject to any U.S. tax filing requirements and thus not covered by the annual reporting requirements proposed in Part III.A.2). This will reduce the burden on partnerships and partners to determine and provide information, and make it less likely that a partnership will be considered a nonqualified entity merely because of documentary issues rather than the substantive position of its partners.

Although the precise thresholds are somewhat arbitrary, we suggest that a partnership with 100 or more partners in a taxable year should have reduced information-gathering obligations compared to partnerships with fewer partners, and that information from partners with a *de minimis* interest should not be required. We suggest that the presumption rules set out below should apply (i) to relatively small partners (e.g., 10 percent or smaller interest in both capital and profits) of widely-held partnerships (e.g., 100 or more partners), (ii) to partners with *de minimis* interests (e.g., 5 percent or less of both capital and profits) in any partnership, and (iii) (to the extent the information discussed above is not available) to upper-tier partners that hold through one or more tiers of pass-through entity.

These presumptions should include the following:

- that the partner includes its distributive share of the partnership income in income currently (whether or not pursuant to an anti-deferral regime);[212] and

- that the partner is subject to a comprehensive foreign income tax (if foreign) or are not tax-exempt (if U.S.).[213]

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[211] The pass-through partner should be able to rely on similar information reports received from its owners.

[212] But *see* Notice Q&A-11(f)(i). We argue in Part IV.E that the inclusion of income pursuant to the application of an anti-deferral regime should be taken into account in determining whether the partner includes the partnership income in its income on a current basis.

[213] *Cf.* Notice Q&A-11(f)(ii)(A)(II) and 11(f)(ii)(B)(I).

We believe that these presumptions need not apply to the extent there are readily apparent objective indicia to the contrary—for example, (i) identification as a Section 892(b) international organization, (ii) identification as a state pension plan claiming constitutional or statutory exemption from federal income taxation, (iii) incorporation in a jurisdiction with which the U.S. does not have a tax treaty, or (iv) actual receipt of the relevant tax information discussed above.[214] In addition, we believe an exception can be made for "actual knowledge" that a partner is not an "eligible person" (within the meaning of Notice Q&A-11). Most U.S. partnerships should have at least jurisdictional information regarding their direct partners (through receipt of Forms W-9 or W-8), and may have knowledge regarding indirect partners as well (e.g., as a result of requirements that the partnership be fractions rule compliant or avoid generating UBTI). But in the absence of such actual knowledge or objective indicia (which might be viewed as an "reason to know" standard), we do not believe that partnerships should have to (in effect) assume that they are nonqualified entities because they cannot establish otherwise.

We further suggest that a U.S. publicly traded partnership be presumed to not be a nonqualified entity. Establishing the identity of partners owning interests in publicly traded partnerships, and the allocations of income to them, would be all but impossible. Moreover, many such U.S. partnerships ("master limited partnerships" or "MLPs") commonly generate income that would be treated as UBTI (in the hands of a tax-exempt partner) or effectively connected income (in the hands of a foreign partner), so the likelihood that such a partnership would be a nonqualified entity is small (although very difficult to establish).[215]

4. <u>Transition Rule.</u>

We believe a transition rule will be necessary pending implementation of the foregoing recommendations. We therefore suggest that for taxable years that begin prior to the time that further guidance is issued, a partnership should not be treated as a nonqualified entity unless a service provider has actual knowledge that more than 20 percent of the partnership's gross income will be allocated to persons other than eligible persons.

B. <u>Gross Income Allocation v. Allocation of Compensation Expense</u>

<u>**Proposals**</u>

- Regulations should be issued to provide a safe-harbor that would deem a partnership to meet the "substantially all the income" test if at least 80 percent

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214 Treasury and the Service may also wish to specify that such "objective indicia" of nonqualified entity status exist under common fact patterns likely to lead to nonqualified entity status. One example might be: (i) the plan sponsor is a private equity fund that generally operates in a manner that it is not viewed as engaged in a trade or business in the relevant jurisdiction in which it made an investment, (ii) any interest, dividends or capital gains received by tax-exempt investors in the fund should be treated as tax-exempt and not subject to UBTI, and (iii) the fund has reason to believe more than 20 percent of its income is allocated to tax-exempt investors whose investments were not debt financed.

215 One or more state pension plans that are not subject to UBTI could own interests in a MLP and so cause it to be treated as a nonqualified entity, but that would be an unusual circumstance.

of the gross compensation expense attributable to the nonqualified deferred compensation plan is allocable to eligible persons.

- Whether or not Treasury and the Service allow a safe harbor based on allocations of gross expense, we suggest that the relevant test should focus on allocations of *net* income rather than gross income (and even more preferably, net book income rather than net taxable income).

- We suggest that in analyzing the allocation of income (whether book income or tax income) special tax allocations should be ignored, including Section 704(c) methodology, Section 743 and 734 adjustments, minimum gain chargebacks, and qualified income offsets.

Discussion

1. Allocation of Gross Compensation Expense

In general, an employer obtains a tax deduction for deferred compensation in the taxable year in which the employee includes the compensation amount in income. The implicit assumption in the taxation of deferred compensation is that the competing interests of the employer (which would generally prefer an earlier deduction) and the employee (who would prefer deferral) would, other things being equal, generally place a natural limit on the deferral component of compensation arrangements. However, this theory breaks down with tax-indifferent payors that do not receive a U.S. tax benefit from a current deduction (for example, a foreign partner of a partnership, where the partner is resident in a tax haven jurisdiction). We understand that Section 457A was targeted at payments of compensation by entities that are indifferent from a tax perspective as to whether their compensation expense is currently deductible.

Assuming this conceptual basis underlies the enactment of Section 457A, we believe that it is more appropriate, in determining whether a plan sponsor partnership is a nonqualified entity, to look to the allocation of the gross compensation expense of the plan sponsor among its partners rather than gross income. Whether or not a partner in a partnership is indifferent to the existence of deferred compensation depends primarily on whether such partner is entitled to a share of such compensation expense.

Notice Q&A-11(b) provides that the relevant allocations for purposes of determining whether a partnership is a nonqualified entity are allocations of gross income. The selection of gross income as the relevant metric is not obviously required by Section 457A(b)(2). Conceptually, we believe that it would be more appropriate and consistent with the policy of Section 457A for the determination to be made with respect to allocations of *gross compensation expense* rather than gross income. Given the express statutory language we do not think that Treasury and the Service have the authority to disregard income allocations in their entirety. We do believe, however, that under the broad regulatory authority of Section 457A(e), Treasury has the authority to issue regulations that provide a safe harbor whereby a partnership would be deemed to meet the "substantially all the income" test if at least 80 percent of the partnership's gross compensation expense attributable to nonqualified deferred compensation would be

allocable to eligible persons in any year that it became deductible.[216] To facilitate such determination, the compensation expense attributable to nonqualified deferred compensation should be made a separately stated item pursuant to Section 702(a).[217] The rule could also be applied on a plan-by-plan basis, so that a partnership would not be a nonqualified entity with respect to a nonqualified deferred compensation plan if the expense attributable to that particular plan is allocable to a partner that has ECI (i.e., as a result of a special allocation provision in the partnership agreement).

2. **Preferred Returns and Other Allocations of Gross Income.**

Although the Notice focuses on gross income, we believe that the relevant determination should focus instead on allocations of *net* income, for reasons similar to the above – as a conceptual matter the relevant item to focus on appears to be the allocation of gross compensation expense attributable to deferred compensation, and for this determination an allocation of gross income is irrelevant.

As a result we believe (contrary to the position taken in the Notice) that it would be appropriate to *ignore* in this determination allocations of gross income to particular partners, including as a result of receiving an explicit allocation of gross income, ownership of a preferred partnership interest, as a result of regulatory allocations (e.g., qualified income offset, minimum gain chargeback apply, notional income allocations under Section 704(c)), or other allocations of gross income (e.g., under rules similar to the proposed partnership non-compensatory option regulations). We suggest, therefore, that the relevant determination look to allocations of residual net income or loss after allocations of gross income have been taken into account.

3. **What is the Relevant "Gross Income"?**

Pursuant Q&A-11(b) of the Notice, in case of a U.S. relevant partnership, the relevant allocations are the actual tax allocations of the partnership for the relevant tax year. In case of a partnership that is not a U.S. relevant partnership, the partnership is deemed to allocate income to a partner to the extent that the partner includes such income in its gross income on a current basis under the tax laws of its country of residence (other than pursuant to an anti-deferral regime), whether or not distributed.

The Notice is not entirely clear whether the allocation of "gross income" looks to the plan sponsor's Section 704(b) book income or tax income and whether other special tax rules that may apply are taken into account (e.g., Section 704(c) methodology, Section 704(c)(1)(C), Section 743 and 734 adjustments, minimum gain chargebacks, qualified income offsets, deferred

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216 Since this determination would need to be made each tax year after there is no longer a substantial risk of forfeiture and before the deferral on the compensation has ended, the "allocation" of compensation expense would need to be done on a *pro forma* basis. As discussed further below, generally such compensation expense would be deemed to be allocated to those partners that were allocated residual net income.

217 Since the nonqualified entity determination is not relevant unless there is a nonqualified deferred compensation plan, there will always be potential gross compensation expense. In the absence of a rule related to compensation expense (even if a gross compensation expense safe harbor does applies), there needs to be a rule describing the treatment of a partnership that has *no* gross or net income to allocate in a given year.

COD income under Section 108(i), etc.). As noted above, we believe that in general allocations of gross income should not be taken into account, and that the appropriate touchstone is the allocation of net income. We also believe that it makes little sense as a policy matter for nonqualified entity status to depend, for example, on what Section 704(c) methodology applies (e.g., whether notional income is allocated because a book loss for a non-contributing partner is subject to the ceiling rule) or whether other regulatory allocations have been triggered.

As a result, we suggest that Treasury and the Service should clarify that "income" for this purpose means solely book income, without regard to special regulatory adjustments.[218] Allocations of book income generally reflect the economics of the relevant partnership (and are, for example, relevant to foreign and tax-exempt partners that are indifferent to tax allocations), and this would avoid issues arising from different amounts of gross taxable income in the hands of the partners than the partnership has in aggregate (e.g., as a result of 704(c) remedial allocations, Section 743 or 734 adjustments, special basis under Section 704(c)(1)(C), etc.). It would also help to avoid the timing and character mismatches that would occur where foreign tax systems (even if generally "comprehensive foreign income taxes") do not recognize currently taxable income allocated to partners under U.S. tax principles, to the extent such allocations differ from cash distributions. The "substantiality" rules of Treasury regulations Section 1.704-1(b)(2)(iii) would naturally serve to police any inappropriate discontinuity between book allocations and tax allocations.

Whether or not book or tax income is the relevant allocation item, however, we suggest that special regulatory allocations should generally be ignored for this purpose. Some of these regulatory allocations (e.g., qualified income offsets and minimum gain chargebacks) serve to reverse prior allocations of loss and deduction, and it seems strange as a matter of principle to generally ignore allocations of loss and then to take into account allocations of gross income that reverse such losses. Taking into account other such special allocations (e.g., Section 743 and 734 adjustments, special basis under Section 704(c)(1)(C), and Section 704(c) remedial method notional income) may make it difficult to determine what the "gross income" of the partnership is, since the gross income from partnership operations may differ from the gross income received by all of the partners in aggregate. Section 704(c) allocations generally reflect economic shifts that occurred *outside* of the partnership, and it does not seem appropriate conceptually to take them into account.

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[218] *Reverse* Section 704(c) allocations reflect economic shifts that occur within the partnership, and we believe it does conceptually make sense to take into account reverse Section 704(c) allocations. Even if Section 704(b) *book* income is generally the relevant item, we believe it would be appropriate to disregard book gain related to partnership revaluations under Treasury regulations Section 1.704-1(b)(2)(iv)(f), and take into account the taxable income subsequently allocated under reverse Section 704(c) principles with respect to such book gain. This would avoid creating nonqualified entity status as a result of the fact that partners are generally never taxed as a result of an allocation of such deemed book gain upon a revaluation.

C. Guaranteed Payments and Section 736 Payments

1. Guaranteed Payments

Background

Until issuance of further guidance, Section 409A and Section 457A apply to guaranteed payments described in Section 707(c) (and rights to receive such payments in the future), only in cases where the guaranteed payment is for services and the partner providing services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.

Proposal

Guaranteed payments that are not the substantial equivalents of salary (e.g., guaranteed payments based on partnership items and not fixed payments or based on a formula related solely to items outside the partnership) should be excluded from Section 457A.

Discussion

Guaranteed payments are fixed payments to a partner "determined without regard to partnership income." Guaranteed payments for services may arise in respect to payments related to retirement from a partnership under Section 736 (discussed below), and more generally from payments that do not depend on a partnership's income. The concept of whether a payment is related to partnership income is not clearly delineated in guidance. Although in many situations it will be clear whether or not a guaranteed payment has been made, there are many other situations in which it may not be clear whether or not a guaranteed payment has been received. Although we believe that guaranteed payments that are the equivalents of (deferred) salary and are clearly guaranteed payments should be covered by Section 457A, we do not believe that it is desirable to have Section 457A apply (including possibly additional income taxes and interest) to payments that are determined based on partnership items and as to which there may be uncertainty as to whether the payment qualifies as a guaranteed payment.

Example 1: Partner B is entitled for the next three years to 5 percent of net partnership profits, but no less than $1 million. It is clear as a technical matter that this payment will be treated as a guaranteed payment if the $1 million is paid and will be treated as a partnership distributive share if five percent of profits are paid. As a factual matter it will not, however, be clear whether or not this is a guaranteed payment until the year of the payment.[219]

Example 2: Partner B is entitled for the next three years to 5 percent of net partnership profits, but no less than $1 million and no more than $2 million. This is the same technical analysis as under example 1, although depending on the facts and circumstances (e.g., extreme

[219] *See* Treasury regulations Section 1.707-1(c), example 2.

likelihood that profits will exceed $40 million) some practitioners may be concerned that the arrangement would be characterized differently.

Example 3: Partner B is providing services to an investment partnership, and is entitled for the next three years to five percent of the partnership returns to the extent they exceed the S&P 500. Although this compensation is clearly related to partnership receipts, Partner B may be entitled to compensation even if the partnership has no net profits because the S&P 500 is down.

Example 4: Partner B is providing services to a U.S. investment partnership investing in U.K. equities, and is entitled for the next three years to five percent of the partnership returns measured in sterling (even though the partnership has a U.S. dollar functional currency). Although this compensation is clearly related to partnership receipts (and profits, viewed in a common sense sort of way), Partner B may be compensated even if the partnership has no net profits from a U.S. dollar perspective.

Example 5: Partner B is providing services to an investment partnership, and is entitled for the next three years to five percent of the partnership gains measured on a mark to market basis, even though the partnership is not technically a mark to market taxpayer. Partner B may be entitled to compensation even if the partnership does not have net profits from a U.S. tax standpoint.

Example 6: Partner B is providing services to an investment partnership, and is entitled for the next three years to five percent of the partnership gains measured under U.S. GAAP, without regard for any differences between U.S. GAAP and U.S. tax accounting. Partner B may be entitled to compensation even if the partnership does not have net profits from a U.S. tax standpoint.

Example 7: Partner B is a purchasing manager for a partnership, and is entitled in year three to five percent of the cost savings generated as compared to projected expenses. Although this payment is clearly related to partnership operations, it is not directly related to partnership profits. (It might, however, be possible to have a similar result by allocating partner B a percentage of partnership gross income and allocating expenses to the other partners based on the projected schedule, so that reductions are for the benefit of the purchasing manager.)

Example 8: Partner B is a manager for a partnership with other partners investing for a limited period of time. Partner B gets payments from the partnership depending on the internal rate of return of the investors, taking into account both cash distributions to the investors and any gains they derive by selling partnership interests. Although Partner B's payment may relate to partnership profits, it is also possible that he could be paid if the partnership has generated losses but the investors have sold interests at a gain. (Although this gain presumably reflects appreciation in partnership goodwill, the partnership may not technically have been permitted to revalue its assets to recognize the gain for book purposes.)

Example 9: Any of examples 3 through 8, but the payment is technically drafted as an allocation of gross profits of the partnership. Does this change the result? The economics will very often be identical.

Example 10: Any of examples 3 through 8, but the payment is drafted as a preferred return of profits, allocating first dollars of profits until a formula amount has been reached. Presumably this is not a guaranteed payment, although if profits are substantially certain the economics may be the equivalent.

The list above is not meant to suggest that any of the above examples are or are not "guaranteed payments," and is not meant to comprehensively identify arrangements that may have uncertain results. It is, however, intended to demonstrate that there are a variety of arrangements in which payments clearly dependent on partnership operations may (or may not) be guaranteed payments, or might be but for technical provisions of a partnership characterizing payments as relating to preferred allocations of partnership net profits or gross profits. We do not believe it is appropriate to have the applicability of Section 457A turn on whether or not a payment is a "guaranteed payment" when there may be substantial technical or factual uncertainty and guidance is lacking.

Because of the differences between Sections 457A and 409A, we do not believe that merely tying the application of Section 457A to a cross-reference to the rules under Section 409A will resolve these uncertainties. Although similar issues may on occasion arise in respect to Section 409A, Section 457A may apply in situations where Section 409A clearly does not apply or, if applicable, would not be violated (e.g., an accrual basis service provider, a fixed payment schedule, or a substantial risk of forfeiture for the entitlement based on the occurrence of a non-service related condition *other than partnership income* related to the purpose of the compensation). As a result, although Section 409A technically does apply to guaranteed payments, in practice the applicability of Section 409A to guaranteed payments is very limited since in many cases the payments would be treated as short-term deferrals for Section 409A purposes even if not for Section 457A purposes.

The proposed concept of "guaranteed payments" should be limited for Section 457A purposes to payments in the nature of salary and other single certain payments. As described above, the concept of "Guaranteed Payments" captures more items than might be viewed non-technically, including arrangements other than single certain payments. We believe that the only guaranteed payments that should be subject to Section 457A are those that are in the nature of salary and other similar payments to employees and non-partner independent contractors. It is that type of payment that raises the same types of concerns that Section 457A generally addresses in the non-partnership context.[220]

Given the potential conceptual issues as to when or whether a guaranteed payment for services will be made, we believe that the Treasury and the Service should exclude guaranteed payments based on partnership items from Section 457A (as would be the case for all of the examples above). This would include, for example, payments to a partner where the partner was entitled to x percent of partnership profits but no less than Y, or amounts tied to revenues, cost

[220] If Treasury and the Service agree with these points, it may be advisable to consider whether similar refinements are appropriate for purposes of Section 409A. Regardless, though, the issues are of potentially greater relevance under Section 457A, as it appears that many guaranteed payments that are non salary-like could well be short term deferrals for purposes of Section 409A, and yet not short term deferrals for purposes of Section 457A.

reductions, savings on purchases or the like. These sorts of payments might be treated as guaranteed payments rather than a partnership distributive share but, like a partnership distributive share, they relate to the ongoing operations of the partnership. In addition, carving out such payments will avoid the need to determine whether any such payment is in fact a "guaranteed payment", where there is no clear technical definition under current law.

We recognize, however, that guaranteed payments can look very much like deferred salary of the sort normally paid to employees or independent contractors and can be simple enough as to avoid the complicated conceptual issues noted above. The sense of the Tax Section's Executive Committee was, therefore, that Section 457A could appropriately cover guaranteed payments such as fixed payments deferred until the occurrence of some contingency (e.g., a bonus paid if there is an IPO or benchmark milestone is met), or payments under a formula (e.g., $1 million paid in five years plus a notional return based on foreign currency changes or LIBOR).

2. Section 736 Payments

Proposal

We recommend that Section 736 payments should be excluded from the application of Section 457A, regardless of whether or not they are exempt from SECA tax.

Discussion

Section 736 payments are liquidating payments in excess of the value of a retired partner's interest in partnership property, other than (in some cases) certain types of unrealized receivables and goodwill. Section 736 payments can be of two types: those determined without regard to partnership income, which are treated as Section 707(c) "guaranteed payments" and (2) those determined with regard to partnership income, which are treated as distributive shares of partnership income. Until further guidance, payments under Section 736 are generally not subject to Section 409A (and therefore Section 457A), unless they qualify for an exemption from self-employment tax (SECA) under Section 1402(a)(10).

The exemption from self-employment tax under Section 1402(a)(10) only applies to retirement payments made (1) on a periodic basis upon retirement to a partner pursuant to a written plan and which continue at least until the partner's death; (2) where the retired partner receiving the payments rendered no services with respect to any trade or business carried on by the partnership during the taxable year of the partnership that ends within or with the taxable year of the partner and in which the payment is received; (3) where no obligation exists from the other partners to the retired partner except with respect to retirement payments under the plan and (4) where the retired partner's share of the capital of the partnership has been paid to him in full before the close of the partnership's taxable year in which the payment is received. If all four requirements are not met in a year (e.g., because the retired partner continues to provide services to the partnership) or there are obligations from the other partners to the retired partner (e.g., the right to receive certain payments in respect of uncollected accounts receivable for certain services performed), the income for that year is not exempt from self employment tax.

With respect to Section 736 payments that qualify for exemption under Section 1402(a)(10) and are thus subject to Sections 409A and 457A, the preamble to the final Section 409A regulations provides that the legal right to such payment is treated as arising on the last day of the partner's taxable year before the year in which such payments are excludible from SECA tax and the services are treated as performed in the partner's first taxable year in which such payments are excludable from SECA tax. As a result, a (retired) service provider can make an election to defer such payments without violating Section 409A.[221]

Since Section 457A does not have a similar sort of provision related to permitted deferrals, it is not clear how these rules will apply in the context of Section 457A.

Example: A partner of a global architecture firm is entitled to payments under a retirement plan until death starting when he reaches the age of 60 provided he continues to provide services to the partnership until he reaches at least the age of 55 or has provided services for at least 25 years (if earlier). The payments consist of an amount equal to 150 percent of the partner's highest annual calendar year compensation during the final four years of service as a partner at the firm (to be paid in 5 equal installments over a specified 5 year schedule) and thereafter x percent of profits per year. Assume that these payments would qualify for exemption from SECA when received. Consequently, the payments are subject to Section 457A when they are no longer subject to substantial risk of forfeiture (i.e., when he reaches 55 or reaches the 25th service anniversary, if earlier). The partner elects under Section 409A to defer the payments until paid out pursuant to the plan's specified payment schedule starting after he reaches 60. If the partnership were a nonqualified entity, the partner would be required to include the payments in income under Section 457A when they are no longer subject to a substantial risk of forfeiture, regardless of the Section 409A deferral election.

Assume that the partnership is not a nonqualified entity when the payments are no longer subject to substantial risk of forfeiture within the meaning of Section 457A, but becomes a nonqualified entity when the payments are still deferred (i.e., more than 20 percent of gross income is not subject to tax as ECI and is allocated to non-U.S. partners that do not pay a comprehensive foreign income tax). If the payments in such year qualify for exemption from SECA, they are subject to Section 457A. If the partner provides services to the partnership in the relevant year so that the exemption from SECA does not apply, it is not clear whether Section 457A applies or not. Based on the preamble it is also questionable whether the Section 409A deferral election is still valid.

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[221] The preamble to the final Section 409A regulations (TD 9321) provides that this "relief" (i.e., ability to elect to defer) does not apply a "second time" if already made previously with respect to a payment under the plan. The rationale behind this rule is not entirely clear, and in any event it is not clear how this rule would affect the analysis under Section 457A. For example, assume an amount under a retirement plan is excluded from SECA tax in year 1 and the taxpayer makes an election under 409A to defer the amount until a specified time; in year 3 the taxpayer provides services to the partnership and can no longer qualify for exemption under 1402(a)(10) (i.e., does not meet second prong of the Section 1402(a)(10) test)). It is not entirely clear why in such a situation such payments would not automatically qualify for non-application of Section 409A since they do *not* qualify for the exemption under Section 1402(a)(10). The preamble suggests, however, that such payments going forward are no longer covered by the election and thus would be subject to Section 409A. They may or may not also be subject to Section 457A under this same rule.

Because Section 736 treats retirement payments under certain circumstances as guaranteed payments (i.e., to the extent they are not determined with respect to partnership income), it is also not entirely clear whether Section 736 payments only need to be tested against the Section 1402(a)(10) exemption or also under the general "guaranteed payment" rule (described above). For example, in the above example the portion of the retirement payment that is keyed off of the retired partner's highest annual compensation as of the last five years prior to retirement would be treated as a guaranteed payment because it is not determined with respect to partnership income. Assuming it does not qualify for exemption from SECA, does it need to meet the general guaranteed payment rule?

We urge Treasury and the Service to issue guidance with respect to the foregoing. Our recommendation is that Section 736 payments (whether treated as guaranteed payments or not) should be exempt from the application of Section 457A, whether or not they qualify for exemption from SECA tax. We strongly recommend, however, that in any case until guidance is released Section 736 payments should not be subject to Section 457A.

D. Comparison to Section 457(f)

Background

Section 457A can be more restrictive than Section 457, in that, if Section 457A applies, no deferral is permitted. In addition, the difference between the broader Section 409A definition of substantial risk of forfeiture which the Service has indicated will be adopted for Section 457(f), and the very restricted services-based definition of substantial risk of forfeiture for purposes of Section 457A, can lead to some surprising results in the context of interests in joint ventures treated as flow-throughs held by domestic tax-exempt entities. A pass-through entity owned by tax-exempt organizations could have been subject under pre-Section 457A law to Section 457 restrictions on deferral, or arguably free of restrictions altogether. Without further clarification by Treasury, the Service, or Congress, it is unclear whether Section 457A's more restrictive rules could be applied in cases which appear to justify treatment no worse than that applicable under Section 457, thereby denying tax exempt organizations the treatment otherwise available under the Code.

In addition, questions can arise regarding whether affiliates of entities subject to Section 457 ("457 Entities") are subject to Section 457A. These questions can become further complicated where entities are owned by a combination of 457 Entities and other entities.

Proposals

We recommend that, where a plan sponsor is a 457 Entity, and all of its equity owners are 457 Entities, Treasury and the Service should clarify that Section 457, and not Section 457A, applies. We also recommend that Congress should amend the statute to provide that, where the plan sponsor is a partnership or joint venture between one or more 457 Entities and one or more other entities, and Section 457A applies solely due to the ownership of the 457 Entities, the plan sponsor may elect that either Section 457 or Section 457A apply.

Discussion

Section 457 permits deferral up to certain specified limitations. Further, if a domestic tax-exempt entity provides nonqualified deferred compensation through a plan which is not an "eligible deferred compensation plan" under Section 457(b), the compensation will not be includable in the income of the participant under Section 457(f) so long as it is conditioned on a substantial risk of forfeiture consisting of the attainment of a condition related to a purpose of the compensation, and not solely on the provision of substantial future services.

Thus, the tax-exempt entity will be able to provide its employees with many common sorts of compensation arrangements based on the attainment of performance goals that are not contingent on continued services, such as post-termination success fees payable upon the disposition of a specified property or portfolio at a profit, increased contributions, reduction of expenses, or the like.

By contrast, if one or more tax-exempt entities form a domestic partnership – or even if one or more tax-exempt entities form a domestic partnership with other taxable partners – then, unless substantially all (generally, at least 80 percent) of the partnership's income is allocated to persons other than the tax-exempt entities, the partnership will be a nonqualified entity. Consequently, because Section 457A where it applies will not permit any deferral, and also because Section 457A prohibits reliance on conditions unrelated to the continued performance of substantial services as a basis for a substantial risk of forfeiture, common compensation arrangements will be unavailable to the employees of the domestic partnership. This result will arise even if the partners of the operating partnership are predominantly taxable entities rather than tax-exempts.

To prevent Section 457A from imposing limitations in these types of circumstances that are more restrictive than might apply to the organization directly, we propose that Section 457 should take precedence over Section 457A where all of the entities in question would be entitled to Section 457 treatment but for their entry into a partnership or joint venture. By the same reasoning, where a partnership or joint venture becomes subject to Section 457A solely because more than 20 percent of its income is allocated to a Section 457 eligible entity, the partnership or joint venture should be entitled to avail itself of Section 457, if it so chooses.

E. Comprehensive Foreign Income Test in the Context of Partnership Rules

The application of the comprehensive foreign income tax test in the partnership context is complex and requires improvement in several areas.

Proposals

We recommend that the current inclusion in income under an anti-deferral regime should count towards meeting the comprehensive foreign income tax test. Further, the burden of proof for establishing that income is allocated to an eligible person should be on the service provider or the plan sponsor rather than the foreign partner. The relevant foreign partner could be an interest holder at some higher-tier partnership. It seems impracticable to impose such reporting requirements on the interest holder.

The special "allocated to itself" rule should apply to any partnership (regardless of whether or not it is the plan sponsor) as long as the partnership is treated as a resident under the laws of a foreign country and is subject to tax on such income.

Finally, guidance should clarify that when determining whether partnership income allocated to a non-U.S. person is treated as subject to a comprehensive foreign income tax, the list of items of nonresidence source income that are not treated as excluded applies.

Discussion

The comprehensive foreign income test as applied to partnerships works slightly differently than with respect to foreign corporations. The Notice looks whether an item of partnership gross income is allocated to an eligible person. An eligible person includes a foreign person who is subject to a comprehensive foreign income tax with respect to such income as provided in the Notice.

A foreign person is subject to a comprehensive foreign income tax with respect to an item of income if (1) the foreign person takes such income into account on a current basis under the income tax laws of the country of which it is a resident (other than pursuant to an anti-deferral regime, such as the Subpart F or PFIC rules or comparable provisions of foreign law) whether or not the income is distributed to such foreign person and (2)(A) in case of a person that is not a non-resident alien individual, such person is not fiscally transparent under the law of the entity's jurisdiction; meets the comprehensive foreign income test (as it applies to foreign corporations; the foreign person being treated as a "foreign corporation" for this purpose) and the income is not excluded from such foreign person's taxable income by means of exemption; or (B) in case of a foreign person that is a non-resident alien individual, such person is eligible for the benefits of a comprehensive income tax treaty with the United States or demonstrates to the satisfaction of the Secretary that such non-resident alien individual is subject to a comprehensive foreign income tax and such income is not excluded from such foreign person's taxable income by means of an exemption.

It is not entirely clear why a foreign person will not be considered "eligible" with respect to an item of income that it is required to include currently in income under some foreign law anti-deferral regime. The focus of the test appears to be that the specific item of partnership income is subject to current tax in a foreign country. This is supported by the fact that the comprehensive foreign income test is a two-fold test – requiring that the income be taken currently into account and that the foreign person be subject to a comprehensive foreign income tax with respect to such income (including that the income not be exempt from tax pursuant to an exemption). If taxes are being paid on a current basis on such income, such current taxation should count for purposes of these rules, regardless of the reason for such result (i.e., whether it is as a result of the application of an anti-deferral provision or simply because of the fact that the foreign country treats the sponsor as a partnership and accordingly taxes the partner on a current basis). Because the test is applied on an item-by-item basis, anti-deferral regimes will only be relevant to the extent they apply to that specific item of partnership income. If certain items of partnership income are not required to be included currently in income under the anti-deferral rules, the allocation of such income items to such person will count adversely towards the nonqualified entity determination. Thus, there is no concern that by taking into account anti-

deferral regimes items of income would be treated as allocated to an eligible person even if they are not subject to current income tax.

Further, the Notice puts the burden of proof for establishing qualification as "eligible person" on the foreign person that receives an allocation of income. As discussed further above, it is unclear how a service provider can obtain the necessary cooperation of such potentially eligible persons.

An item of partnership income may be treated as allocated to a partnership itself if the partnership is treated as subject to comprehensive foreign income tax with respect to such item of income (e.g., for example where the partnership is treated as a corporation under the law of the country in which it is a resident). However, in case of a domestic partnership this special "allocated to itself" rule only applies where the partnership is the sponsor. Consequently, the rule does not apply to income allocated to a high-tier domestic partnership that is an interest holder in another partnership that is the plan sponsor. Notice Q&A-11(e)(iv), which provides that a domestic partnership will be treated as a foreign person (and thus an eligible person) only if it is the sponsor of the nonqualified deferred compensation and is treated under the laws of a foreign country as resident in that country for tax purpose.

For example, a U.S. partnership is the sponsor of a plan and has two partners – a U.K. individual and a U.S. LLC. The income of the sponsor partnership is not treated as ECI. Assume the LLC partner is managed out of Brazil and as result treated as resident of Brazil and subject to tax in Brazil on its income. Under the Notice, the U.S. LLC is not an eligible person regardless of the fact that it is subject to tax in Brazil on the income items from the sponsor partnership, because it is not the sponsor of the plan. Because Brazil taxes the LLC as a corporation, the interest holders in the US LLC are not subject to current tax in Brazil on the partnership income. Consequently, they are also not eligible partners either. There does not appear to be any conceptual reason that this rule only applies to domestic partnerships that are the plan sponsors, while if the US LLC were a foreign LLC income would be treated as allocated to the LLC regardless of whether it is the plan sponsor.

Notice Q&A-11(f) requires that an item of income (when allocated to a foreign person) not be excluded from such foreign person's taxable income by means of an exemption in order to be treated as allocated to an eligible person. While the Notice contains a list of "good income" items that are not counted as excluded for purposes of the nonqualified entity determination with respect to foreign corporations (e.g., dividends from corporations substantially all of the income of which is subject to a comprehensive foreign income tax), the Notice does not reference this list or include something similar for purposes of the "eligible person" determinations with respect to partnerships.[222]

Example: A foreign partnership holds interests in a French subsidiary. One of its partners is a Luxembourg corporation, which is exempt from tax in Luxembourg on its distributive share

[222] *See* Notice Q&A-11(f), which cross-references Q&A-8(a)(i)-(ii) of the Notice, but not Notice Q&A-8(c)(vi). Where such excluded income is income that is subject to tax as ECI, it would not appear to matter that it is not picked up by the Notice as "good" excluded income item, because such income would be treated as allocated to an eligible person to the extent the foreign partner is subject to tax on it under a separate rule. *See* Notice Q&A-11(e)(ii).

of the French subsidiary's dividend income. Under the Notice, it appears that such dividend income is not treated as allocated to an eligible person to the extent it is allocated to the Luxembourg parent. We believe this should be clarified. We see no justification for not applying the same standards for determining eligible person status as are applied for determining the nonqualified entity status of a foreign corporation.

V. Investment Asset Exception

Section 457A(d)(1)(B) permits the Treasury to promulgate regulations that would expand the definition of "substantial risk of forfeiture" in the case of compensation that is determined solely by reference to the amount of gain recognized on the disposition of an "investment asset." To the extent provided in the regulations, this type of compensation would be treated as subject to a substantial risk of forfeiture until the date of the relevant disposition. The Notice specifically asks for guidance regarding the potential scope of this exception.

As prescribed by Section 457A(d)(1)(B), this exception would provide that compensation determined solely by reference to the gain recognized on disposition of an "investment asset," is not taxed until such disposition. For these purposes, Section 457A(d)(1)(B) provides that the term "investment asset means any single asset … (i) acquired directly by an investment fund or similar entity, (ii) with respect to which such entity does not … participate in the active management of such asset (or if such asset is an interest in an entity, in the active management of the activities of such entity), and (iii) substantially all of any gain on the disposition of which (other than such deferred compensation) is allocated to investors in such entity."

A. Adoption of Regulations

Proposal

We propose Treasury adopt regulations including the investment asset exception suggested by Section 457A(d)(1)(B), and that consideration be given to allowing taxpayers to rely on the single asset exception contained in the Code with respect to deferred compensation attributable to services that are performed prior to the promulgation of regulations. We strongly urge that guidance be issued to clarify some of the uncertainties associated with the current wording and the terms used in this exception.

Discussion

As the statute specifies the exception will apply "[t]o the extent provided in regulations," it appears that the investment asset exception is not self-executing. Failure to adopt an investment asset exception in any form would be clearly inconsistent with congressional intent. Because of the significant penalties that apply to deferred compensation amounts subject to Section 457A that are "not determinable," taxpayers need guidance upon which they can rely as

soon as possible. Under the Notice, the amount of gain recognized on disposition of an investment asset would not be "determinable" before such disposition occurs.[223]

B. Application to Typical "Side Pocket" Arrangements

Proposals

We recommend that Section 457A should be amended to broaden the scope of the exception, so as to exempt compensation arrangements related to the management of illiquid and hard-to-value investments (including standard side pocket arrangements). Thus, regulations should make the exception applicable to the type of structures that have evolved in the market place.

We further recommend that (at least during the interim period prior to amendment of the statute), in a circumstance in which compensation paid to a service provider is determined according to the profits from one or more investment assets (i.e., under a broader "investment asset" standard that reflects current market practices), Treasury and the Service should apply the Section 409A short-term deferral exception utilizing the Section 409A definition of substantial risk of forfeiture.

Discussion

Many hedge funds and similar private investment arrangements may invest a portion of their total capital in illiquid or hard-to-value investments. Such investments are notionally segregated from the marketable securities (i.e., to exclude them from periodic redemptions, etc.). The funds establish "side pocket" accounts to track the economic performance of these investments. Because the assets are illiquid and/or hard to value, investors are typically unable to withdraw from such side pockets until gain is realized, even if they have otherwise withdrawn from the fund. Fund documents often restrict managers from receiving fees on these investments until a return on the investments is realized or the investments become more liquid or can otherwise be appropriately valued. Accordingly, performance fees (and in certain cases management fees) with respect to such investments generally are paid with respect to gains or other income from the side pocket assets on a realization basis (rather than the standard mark to market fees paid with respect to the hedge fund investments generally). Similarly, many pension plans increasingly hold their investments in separately managed accounts and compensate their investment managers with fees that are paid in respect of gains or other income from these specific investments on a realization basis. There are also other investment or property management relationships (e.g., real estate partnerships and management of intellectual property rights) in which compensation is commonly based on realizations of profit.

To the extent the fund manager is not treated as subject to a substantial risk of forfeiture with respect to incentive fees related to these side pocket investments at the time they are made,

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[223] As discussed in Part II.H.3 herein, we believe service providers should be allowed to elect to treat any deferred amounts as "determinable" based on reasonable projections, with Section 457A(c)(1)(B) penalties imposed only on the excess of the amount ultimately received over such projections.

Section 457A would apply.[224] Since the incentive fee is based on the realized profits from the side pocket investment and the amount is generally not determinable at the time the side pocket investment is made (and when there is no longer a substantial risk of forfeiture), the fee would, when received, be subject to the Section 457A penalty tax regime, unless the investment asset exception is applicable.

The investment asset exception has been publicized as being aimed at such "side pocket" compensation arrangements. If this is correct, it would mean that the traditional deferral of incentive fees paid to fund managers would still be proscribed by Section 457A but the receipt of incentive fees tied to the realization of illiquid investments would still be permissible. However, for the reasons discussed below, the exception as provided in the statute is drafted too narrowly to be applicable to most (or perhaps all) of these arrangements as they are currently structured.

It is difficult to understand the scope and purpose of the statutory language if it is to be viewed as defining a class of side pocket or similar arrangements, because it is not clear to us that any such arrangements would qualify as an "investment asset." We believe that, perhaps, the statutory language was drafted not so much to define a "permissible" side pocket arrangement as to exclude from the scope of the "investment asset" exception nonqualified deferred compensation arrangements that (in the absence of the exception) would not have been based on proceeds from the sale of assets at all. So, for example, the statutory requirement that the relevant profits must relate to a single asset and to gains on that asset might be designed to prevent formulaic returns that are then grafted onto the returns from one or more assets (e.g., the first $1 million of gross proceeds to be received from the sale of any of five assets might be a substantially certain amount of money at a time within the control of the employee). Or possibly the single asset rule was intended to prevent deferrals of income inclusion where an entitlement to income existed but was deferred until all underlying assets had been disposed of. Unfortunately, the legislative history provides no further insight into the reasons for the narrow definition of "investment asset."

The following four proposals are more specific suggestions for how the investment asset exception could be interpreted, or changed, so that it would be applicable to the type of structures that have evolved in the market place.

1. Netting

Proposal

Congress should amend the statute to extend the investment asset exception to amounts determined by solely reference to the net profits on a pool of illiquid or hard-to-value investments, whether or not netted against losses on other assets, as is typical in the calculation of performance fees related to "side pocket" arrangements.

[224] We assume that the fund is a nonqualified entity. The application of the Section 457A "substantial risk of forfeiture" rule may be uncertain in a circumstance in which the fund manager has effective control over whether or not it will perform such services.

In any event, Treasury and the Service should clarify that netting is allowed within a pool of similar assets that is viewed as a single mass asset from a commercial standpoint.

Discussion

A typical side pocket is used to track the performance of more than one investment. Accordingly, gain on disposition of these investments is calculated net of any losses on disposition of other investments in the side pocket. In addition, as fund managers generally receive a performance fee only to the extent that the overall performance of the funds improves year over year, proceeds eventually realized on a side-pocket investment are included together with the performance of the rest of the portfolio for purposes of assessing performance and calculating the performance fee. Side pockets may also be subject to a high water mark requirement, under which (in effect) prior losses on other assets will offset income on the assets in the side pocket.

The legislative history specifies that arrangements featuring any netting are intended to be excluded from the investment asset exception.[225] This interpretation seems to derive from fact that Section 457A(d)(1)(B) defines an investment asset as "any single asset." It is possible that Congress added the "single asset" requirement so that a manager could not avoid the ordinary year-to-year assessment and inclusion of fees on an entire portfolio merely because certain assets were illiquid. While standard netting would not present an opportunity for abuse, using the excuse of a few illiquid assets to delay fees on an entire portfolio of otherwise liquid assets would and the use of the term "single asset" could be intended to prevent this type of abuse. We recommend Congress explicitly extend the exception in cases where fee recognition delays relate to assets for which the fee is determined upon realization and not a delay of the regular periodic fees on the rest of the portfolio.

The prohibition on netting severely restricts the extent to which the investment asset exception applies to any existing side pocket arrangements. Virtually all funds net the returns from side pocket investments against the performance of the portfolio as a whole. To do otherwise would allow managers to take performance fees on successful sales of side pocket investments, while investors suffered a net loss across their entire fund investment. The commercial reality is that investors will not allow funds to cherry-pick gains. It also seems unlikely from a policy perspective that Congress intended to preferentially treat arrangements that provide for a misalignment between the investors' and the manager's interests. Thus, if the investment asset exception does not allow typical netting arrangements, then the exception would provide little or no relief for funds as they are currently structured. Given that the exception was consistently acknowledged as providing practical relief for side pockets and similar arrangements, the legislative history suggesting a prohibition on netting may indicate a misapprehension of fee structures in the marketplace.

Typical netting arrangements do not present a loophole or opportunity for abuse. As the investment asset exception appears to be intended to operate, it would require that an investment

[225] Blue Book at 532 ("[T]he rule does not apply in the case of an arrangement under which the amount of the compensation is reduced for losses on the disposition of any other asset.") This language is also contained in prior House Reports, the H.R. 6049 JCT Explanation and the H.R. 7060 JCT Explanation.

manager include in income any and all incentive fees to which the manager becomes entitled as a result of a realization event. The fact that a manager is required to net realization proceeds against the performance of the rest of the portfolio merely means that the manager's fee may be reduced as a result of losses in the rest of the portfolio. Standard netting arrangements do not introduce the possibility of a further deferral of fee recognition. Accordingly, netting is consistent with the investment asset exception and there is no policy reason to prohibit it.

Even if our general proposal to allow netting is not adopted, Treasury regulations should clarify that the term "single asset" also includes a pool of fungible or similar assets (e.g., a pool of mortgages, a pool of credit card receivables, or plots of land for development). An investment in such a pool could be treated for tax purposes as beneficial ownership of the many assets contained in the pool, but it would generally be viewed as a single mass asset from a commercial standpoint, and in practice it would be impossible to hold or measure each such item in the pool as a separate asset. Treating such a pool as a "single asset" for purposes of the investment asset exception would allow taxpayers to combine investments of such assets in one side pocket and would allow the netting of losses from some assets in the pool against gains and income from other assets in the pool.

2. Income Not Attributable to Gains from Disposition

Proposal

To the extent Treasury feels is permissible under the statute, regulations should allow the inclusion of at least some current income in the determination of the performance fee. We also recommend Congress consider replacing the current drafting in the statute with a requirement that compensation be determined solely by reference to the amount of income generated by the asset and the amount of capital gain recognized on the disposition of the asset.

Discussion

Section 457A(d)(1)(B)(i) further provides that the exception applies only if the compensation is determined "solely by reference to the amount of gain recognized on the disposition of an investment asset." If this section is read literally, the exception would not apply to any compensation arrangement that includes current income such as dividends, interest, rents and royalties in the determination of the performance fee. Side pocket investments, however, commonly provide for the payment of management fees based upon all cash generated by the investment such as dividends in a recapitalization, royalties, interest, rents, etc. Other investments (aside from hedge fund side pockets) that might fall within the investment asset exception (private equity or real estate transactions) also generally would not have compensation for the investment manager dependent solely on gains from disposition. While we recognize the statutory language is restrictive, we see no policy reason why the inclusion of current income should preclude a side pocket arrangement from qualifying for the exception. Even if Congress does not amend Section 457A, Treasury and the Service should clarify that "gain recognized on disposition" may include net profits that are not capital gains.

3. Acquisition through Blockers or Other Intermediary Vehicles

Proposal

We recommend that the regulations clarify the requirement that an investment asset be "acquired directly by an investment fund or similar entity." In particular, this phrase should not be interpreted so as to preclude the acquisition of the investment asset through a blocker corporation, a master fund, or a partnership with other parties (e.g., with members of an investment consortium).

Discussion

We believe the "direct" acquisition requirement may be interpreted to mean that the fund must actually own the asset (i.e., beneficial tax ownership) as contrasted to a derivative interest. Therefore the requirement should not be violated as a result of the investment being held through a blocker or other intermediary vehicle. Guidance should provide that investments that are made together with an onshore feeder through a master feeder vehicle should not be excluded as a result of the "direct" acquisition requirement. Similarly, the exception should apply to an investment made through a co-investment vehicle with other unrelated members. We see no reason why the interposition of a blocker corporation or other vehicle should be a reason for not allowing the compensation determined with respect to such investment to qualify for the exception.

4. Management Rights

Proposal

We recommend that guidance clarify the application of the "active management" restriction. In particular, contractual management rights that are equivalent to shareholders' rights should not be viewed as active management, and so-called "activist" funds should not be viewed as exercising active management by using their shareholders' voting rights as leverage for advocating substantial changes.

Discussion

Section 457A(d)(1)(B)(ii)(II) limits the application of the investment asset exception if there is active management of the underlying investment by the service provider (or any person related to such entity). This requirement could be problematic for certain types of funds intended to fit within a regulatory exception to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). An ERISA regulation provides that ERISA does not apply to the assets of entities that are "venture capital operating companies." In order to qualify as a "venture capital operating company", a fund would need to have "management rights" in a proportion of its investments and would need to exercise its "management rights" in at least one of its investments each year.

According to the legislative history, "[a]ctive management is intended to include participation in the day-to-day activities of the asset, but does not include the election of a

director or other voting rights exercised by shareholders."[226] The regulations should make clear that direct contractual rights, such as "management rights" between a fund and its investment, should not be viewed as active management if such rights are the equivalent of shareholder rights. In particular, guidance should clarify that having a management rights letter as required for VCOC purposes or exercising the (ordinarily passive) rights provided by such letter should not violate this requirement. Guidance should similarly clarify that promoting (or agitating) for a corporate or financial reorganization, as is commonly done by activist funds, should not be treated as active management.

5. Limitation on Allocation of Gain

The meaning of the requirement of Section 457A(d)(1)(B)(ii)(III) ("substantially all of any gain on the disposition of the asset (other than such deferred compensation) is allocated to investors in such entity") is not clear. Who else would ever be allocated gain? Moreover, the payment of compensation generally gives rise to a deduction, not an allocation. Guidance should be issued as to whether an "allocation" in this context refers to something other than a partnership distributive share (as is suggested by the idea that deferred compensation might constitute such an allocation) and, if so, the scope of the term "allocation."

Unless the purpose for this provision can be clarified through regulations or other guidance, we recommend amending the statute to delete it.

6. Relevance of Terms that (Retrospectively) were Not Applicable

Guidance should clarify whether the investment asset exception is determined in the abstract (e.g., whether it is possible under the terms of the side pocket for a high water mark to be relevant or for current income on the side pocket to be taken into account) or based on the actual computation (e.g., was the compensation in fact affected by current income).

The former approach may be preferable because it will allow taxpayers to determine at the time of creation of the side pocket investment whether the exception would be applicable; while the latter approach may be helpful in allowing compensation arrangements that have not been structured with the requirements of the Section 457A exception in mind to qualify for the exception. This Report does not take a position, other than to request clarity.

7. Regulations Regarding Short-term Deferral

Proposal

We recommend that, at least prior to the statutory amendments discussed in Part V.B.1, regulations should provide that in a context in which compensation is based on solely one or more illiquid or hard to value investment assets, whether or not netted against losses on other investments (i.e., the investment asset exception, modified as proposed above), a "nonqualified deferred compensation plan" for Section 457A purposes should take into account whether there

[226] Blue Book at 533. The same language is also contained in prior House Reports, the H.R. 6049 JCT Explanation and the H.R. 7060 JCT Explanation.

is a short-term deferral under Section 409A guidance, *taking into account* for this purpose the meaning of "substantial risk of forfeiture" provided for in Section 409A.

Discussion

As noted above, the investment asset exception as drafted will be of no relevance to most or possibly all side pocket arrangements. Although we cannot speak comprehensively, we are unaware *of any* nonqualified deferred compensation arrangements in practice (whether or not side pockets) that would actually satisfy the investment asset requirements. Under the assumption that the investment asset exception was not intended to be a dead letter, we believe that Treasury and the Service should endeavor to reflect the drafter's intention that there be a usable investment asset exception, to the extent their authority allows them to do so.

Although we do not believe that Treasury and the Service have the authority to disregard the plain language of the statute and interpret the "single asset" requirement to mean "multiple assets with netting," we do believe that there is authority to interpret whether a "plan" of nonqualified deferred compensation exists if it is paid or included within the short-term deferral period under Section 409A. The Notice, in Q&A-A(2)(c), has taken the position that in applying the definition of "deferred compensation" for purposes of the Section 409A short-term deferral exception, the Section 457A definition of "substantial risk of forfeiture" should apply rather than the Section 409A definition. While this Report does not disagree with this position in general, we believe that Treasury and the Service could reasonably have interpreted the statutory definition of "nonqualified deferred compensation plan" – which is the meaning given such term under Section 409A(d), with a slight modification applicable to appreciation in equity units – to mean exactly what is provided for under the regulations applicable to Section 409A(d). We also believe that Treasury and the Service could utilize this broader reading of the Section 409A short-term deferral exception in limited circumstances (i.e., where compensation is tied to an investment asset), without negating the general rule currently provided for in the Notice.

If this broader reading of the Section 409A short-term deferral exception were to apply for purposes of Section 457A until the proposed statutory amendments are implemented, where the compensation relates to the profits from illiquid or hard to value investment assets, it would as a practical matter allow asset managers to continue to be compensated without drastic, uncommercial modifications to their arrangements.

C. **"Mini-Master" Structures**

Background

Generally, Section 457A does not cover the receipt of partnership capital or profits interests.[227] Presumably the conceptual basis for this is that partners in a partnership are

[227] *See* Notice 2005-1, 2005-1 C.B. 274, Q&A-7, and Preamble to Final regulations under Section 409A, TD 9321 ("Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7…"). The Blue Book specifies that it is not intended that Section 457A can be "avoided through the use of 'springing' partnerships or other entities or rights that come into existence in the future and serve a function similar to a conversion right." Blue Book at 529. We believe that the partnership profits interests discussed in this section would not constitute such "springing" interests, which we understand to be partnership interests which are delivered to the service provider on a deferred basis (i.e., a partnership

currently allocated their distributive share of income, whether or not distributed, and so there is not the same possibility of income deferral as with a fee arrangement. Accordingly, if side pocket assets are held through a "mini-master" structure in which the assets are held in a partnership and the manager or an affiliate receives a partnership distributive share of gain (i.e., in effect, a partnership carried interest), such interest should not be subject to Section 457A.

Proposal

Interim guidance, upon which taxpayers may rely, should clarify that unless the Section 409A regulations are amended to include partnership interests within their scope, the restructuring of side pocket arrangements as "mini-master" partnerships will be respected, and consequently interests in such partnerships will be exempt from Section 457A.

Discussion

Under current rules, interests in a "mini-master" partnership would be exempt from Section 457A. Accordingly, new funds are likely to structure investments in illiquid assets in this manner. However, existing funds that intend to replace their fee arrangements with respect to side pockets with such "mini-master" partnership interests, because they believe they will not meet the requirements of the investment asset exception as currently set forth in the statute, may be concerned that the Service may attempt to recharacterize the new arrangements as disguised nonqualified deferred compensation. Section 457A seems partly designed to dissuade nonqualified deferred compensation plans from being adopted, and therefore the Service should not disregard changes to existing fee structures designed to replace nonqualified deferred compensation with other forms of payment. Treasury and the Service should confirm, perhaps through an example, that existing side pocket arrangements may be restructured as "mini-master" partnerships that will not be treated as nonqualified deferred compensation for purposes of Section 457A.

D. Transition Rule

Proposal

Guidance should clarify how Section 457A applies to side pocket arrangements that have been created prior to January 1, 2009, but that have not yet been realized. Our recommendation is that these arrangements should be covered by the transition rule to the extent the service provider was entitled to the compensation at the time the side pocket investment was made, even though the investment only appreciated after January 1, 2009.[228] If, however, these structures are subject to Section 457A and are not covered by the transition rule, guidance needs to provide that they can be amended to meet the requirements of the exception without triggering income recognition to the service providers.

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analogue of an RSU) or which do not come into existence until a certain triggering event (e.g., an option on a disregarded entity).

228 Compensation received with respect to side pockets is generally received upon the occurrence of a future event, and not on a pre-determined date. *See* discussion under Part VI.A.2 below.

Discussion

It is unclear whether existing side pocket arrangements that have been established prior to January 1, 2009 are exempt from Section 457A or are subject to the transition rule. Under the transition rule, any compensation for services performed before January 1, 2009 that is deferred past January 1, 2018, becomes taxable in either 2017 or (if later) the first year in which there is no substantial risk of forfeiture.

To the extent that the service provider was entitled to the compensation at the time the side pocket investment was made (i.e., the receipt of the compensation was not conditioned on the continued performance of services) and where such investment was made prior to January 1, 2009, these arrangements should not be viewed as relating to services performed after January 1, 2009. The fact that the amount of the compensation under such arrangements depends on the future appreciation of the asset, which may occur in periods after January 1, 2009, should be irrelevant.

As such, they should be covered by the transition rule, which means that they would become taxable on the last taxable year beginning before January 1, 2018 (if not required to be included in income earlier due to a realization event). They cannot be taxable at a later period because they are no longer subject to a substantial risk of forfeiture.

If Treasury and the Service believe that compensation with respect to such pre-January 1, 2009 investments relates to services post-January 1, 2009, because the magnitude of such compensation is contingent on future services, guidance should provide how such arrangements can be restructured to meet the requirements of the Section 457A investment asset exception (including by substituting a profits interest in a partnership/mini-master fund structure for existing deferred compensation).

VI. Transitional Rules

The enactment of Section 457A has created numerous difficulties with respect to arrangements in existence at the time of enactment. These difficulties are exacerbated by the fact that many taxpayers were slow to learn of Section 457A and understand its impact on their arrangements (impact which, in many cases, did not become evident until the release of the Notice on January 8, 2009).

A. Grandfathered Amounts

1. Determination of Plan Sponsor with respect to Grandfathered Amounts Payable After 2017

Background

In general, Section 457A applies only to amounts deferred which are attributable to services performed after December 31, 2008. However, even an amount attributable to services performed before 2009, if not included in income in a taxable year beginning before 2018, must be included in income in the later of the last taxable year beginning before January 1, 2018 or the first taxable year in which the amount is not subject to a substantial risk of forfeiture. For

example, if an individual acquired a legally binding right before 2009 to compensation of $100x, not subject to a substantial risk of forfeiture, which amount is deferred under a nonqualified deferred compensation plan and payable in 2018 (or thereafter), that compensation will generally be includible in the individual's income in 2017 under Section 457A if the plan "sponsor" (as that term is defined in Notice Q&A-14) is a nonqualified entity. This means that even for fully grandfathered and vested amounts the taxpayer must determine whether the relevant plan sponsor was a nonqualified entity as of the relevant dates.

Under the Notice, the sponsor is the entity which, if the deferred amount had been paid in cash in the taxable year (or years) that is (or are) relevant to the determination of whether the entity is a nonqualified entity, would be entitled to a compensation deduction under U.S. tax principles. Although not entirely clear, it would seem that the first relevant year, in a situation in which the deferred amount was never subject to a substantial risk of forfeiture, would be the year in which the employee acquired a legally binding right to the payment, possibly long before the enactment of Section 457A.

Proposal

Future guidance should make clear that any reasonable method may be used by the service providers to determination whether a plan sponsor is a nonqualified entity on any date relevant to the application of Section 457A, including but not limited to chronological proration over the time interval during which the service provider rendered to each entity the services to which the deferred amounts are attributable. We believe that Treasury and the Service should expressly provide that one example of a reasonable method for determining if a plan sponsor is a nonqualified entity should be to evaluate the plan sponsor from and after the time at which Section 457A became effective (i.e., January 1, 2009), without looking back to prior periods. Consideration should also be given to permitting the service provider to elect to treat the entity that was the principal obligor or administrator of the plan as the sponsor of the plan for Section 457A purposes to the extent of amounts attributable to services rendered before 2009.

Discussion

It is not uncommon for a nonqualified deferred compensation plan to be adopted by the parent entity of a multinational group for the deferral of compensation of employees of the parent and its subsidiaries. The employees and activities of those subsidiaries may be located in many different countries. An executive of such a group may have provided services to various different subsidiaries within the group over a period of years, while remaining covered by the same plan, and neither the employee nor the service recipients may have had any reason to keep track of which entity or entities would be entitled to a deduction for compensation under U.S. tax principles with respect to compensation deferred under the plan. In such circumstances, it may be extremely difficult to determine in 2009 or thereafter which entity or entities were the sponsoring entities with respect to pre-2009 compensation, and to what extent.

2. Determination of Grandfathered Amounts where Substantial Risk of Forfeiture Lapses on an Event

Background

Notice Q&A-23(a)(1)-(3) provide rules for determining the period of Service to which compensation is attributable. However, great confusion remains regarding application of the rules set forth in Notice Q&A-23(a)(1)-(3) and the examples set forth in Notice Q&A-23(b) to compensation that vests on the occurrence of a future event (i.e., the lapse date of the substantial risk of forfeiture is not a number of years) where, as of December 31, 2008, such event has not occurred and there is no certainty as to whether or when such event will occur.

One example of uncertainty regarding application of the rules contained in Notice Q&A-23(a)(1), (3) is illustrated by a payment that is conditioned upon a sale of the company that also requires the service provider to be employed on the date of such sale. Notice Q&A-23(a)(1) provides that to the extent that compensation is not attributable to services performed in a particular period, "then the compensation generally is attributable to services performed during the year in which the employee obtains the legally binding right to the compensation." Notice Q&A-23(a)(3) provides that unless compensation is attributable to a different period under the rule in Notice Q&A-23(b)(1), compensation that is subject to a substantial risk of forfeiture is attributed, on a pro rata basis, to the period during which the service provider is required to continue to perform substantial future services.

Proposal

Where a substantial risk of forfeiture lapses on a date that is based on a future event and not a specified period of service, the payment should be attributed to the year in which the employee obtains a legally binding right to the compensation. Future guidance should make this reading of the rules explicit.

We believe that the better reading of the rules, when read together, is that where a substantial risk of forfeiture lapses on a date that is based on a future event and not a specified period of service, the rule in Notice Q&A-23(a)(1) applies and the payment is attributed to the year in which the employee obtains a legally binding right to the compensation. Any alternative approach creates great difficulty in trying to determine whether amounts are grandfathered for purposes of Section 457A (as otherwise the determination would not be possible until the event at issue otherwise occurred).

B. Nongrandfathered Amounts

1. Transition Relief Extension

Background

Section 457A will generally apply with respect to a nonqualified deferred compensation plan established before 2009 by a nonqualified entity, if additional amounts are earned under the plan, or previously earned amounts cease to be subject to a substantial risk of forfeiture, after 2008. In many situations involving such plans, service providers (and service recipients) are not

yet aware, or are only now becoming aware, of the applicability of Section 457A. Indeed many arrangements which appeared to many practitioners, on the face of the new provision, to be excluded from the scope of Section 457A – particularly those where the service provider was an accrual basis taxpayer and those where the arrangement constituted a short-term deferral under Section 409A – were only determined to be subject to Section 457A upon the publication of the Notice.

Notice Q&A-23(a)(4) provides for extremely limited transition relief with respect to amounts deferred that are attributable to services performed after December 31, 2008, including amounts deferred under plans and arrangements that long predated enactment of Section 457A. The extent of the relief is to permit amendment to the terms of a plan terms prior to July 1, 2009, to vest any deferred amounts as of December 31, 2008, thereby treating these amounts as grandfathered and avoiding the application of Section 457A to those amounts so long as payment is made before 2018. However, even where service providers became aware of the potential applicability of Section 457A sufficiently in advance of July 2009, most were not in a position to benefit from this limited transitional relief. The amendment contemplated by the transition relief would typically require the consent of parties other than the service provider or service recipient, such as of investors in the service recipient, who generally do not have any obligation or desire to accelerate the vesting of compensation rights to a date any earlier than the vesting date or schedule set forth under the previously negotiated agreement concerning the provision of services. It is commonly the case that, once the terms of a fund or other investment or venture have been established and the investors have acquired interests therein, any change to the manner in which the service providers are compensated may require the consent of numerous investors unrelated to the investment advisor or each other, with respect to whom negotiation of such matters may be difficult or impossible as a practical matter.

Proposal

The cutoff date under the above-referenced transitional rule in the Notice should be extended to no earlier than June 30, 2010 in order to permit taxpayers who are able to utilize this relief a meaningful period of time to analyze the consequences of doing so, communicate with other stakeholders, and accomplish the required amendments.

2. Additional Transition Relief

Background

Even the extension requested above, although helpful in some situations, will not provide any relief in the many situations where the service recipient or its owners or other stakeholders are not amenable as a business matter to the acceleration of vesting. Further, although Notice, Q&A-25 and Q&A-26 generally provide that a deferred amount may be paid at the time the amount becomes includible in income under Section 457A without such payment being considered an impermissible acceleration under Section 409A (which may be helpful in some situations), no relief at all is available to those service providers who are entitled to amounts which are not determinable at the time the amounts cease to be subject to a substantial risk of forfeiture under Section 457A. These service providers (and there are a great many, as this is a very typical fact pattern) have no opportunity to avoid the additional 20 percent tax and interest

charge, even with respect to arrangements that may have been executed long before the enactment of Section 457A and that the service provider has no ability to amend.

Proposal

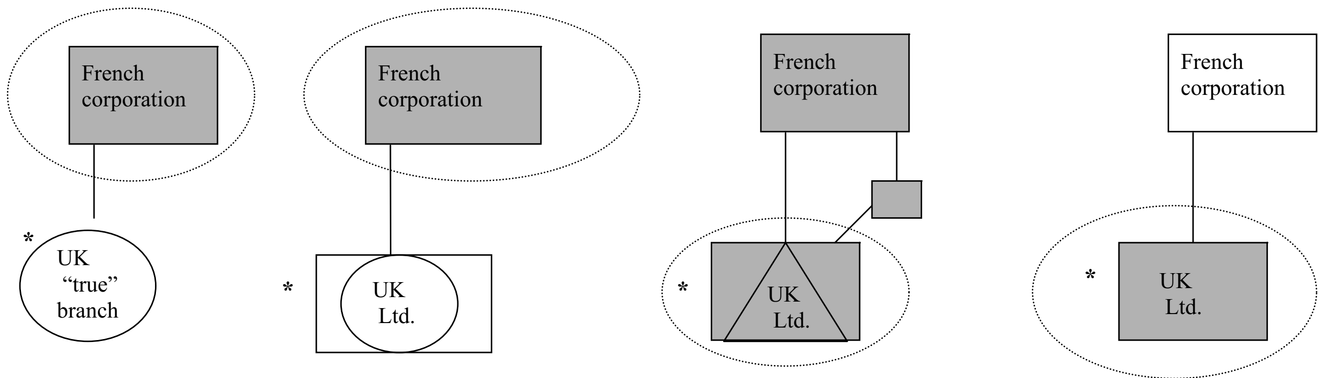
A further transitional rule should be provided for nongrandfathered amounts. One approach would be to permit service providers to make an election, within some specified interval (perhaps within one year after the issuance of the rule), to include the fair market value of the right to deferred amounts in income immediately, notwithstanding the continued deferral of receipt and notwithstanding that the amounts may not, at the time the election is made, be "determinable" under the standards referred to in the legislative history and in the Notice.

Discussion

For the purposes of this election, the right to deferred amounts would be required to be valued on the basis of reasonable projections and without regard to any ongoing risk of forfeiture. This election would be somewhat analogous to the election long permitted under Section 83(b) with respect to the transfer of property subject to a substantial risk of forfeiture. The consequent immediate inclusion in income would seem to eliminate the potential for abuse at which Section 457A is directed, so long as the valuation of the right to deferred amounts is reasonable. If deemed necessary to avoid the potential for abuse, a service provider could be required, as conditions to making such an election, to (i) consent to extend the period of time during which additional tax could be assessed (by reason of an understatement of tax liability attributable to the undervaluation of the right to the deferred amount) beyond the end of the normal statute of limitations period for the taxable year for which the election is made, and (ii) grant to the Service the authority to make a retroactive adjustment to the income inclusion reported for the year of the election by reason of the right to deferred amounts taken into income if, upon audit, it was determined that the valuation of the right was unreasonable in the first instance.

Appendix A – Illustrative Examples

“Plan Sponsor”



Notes:

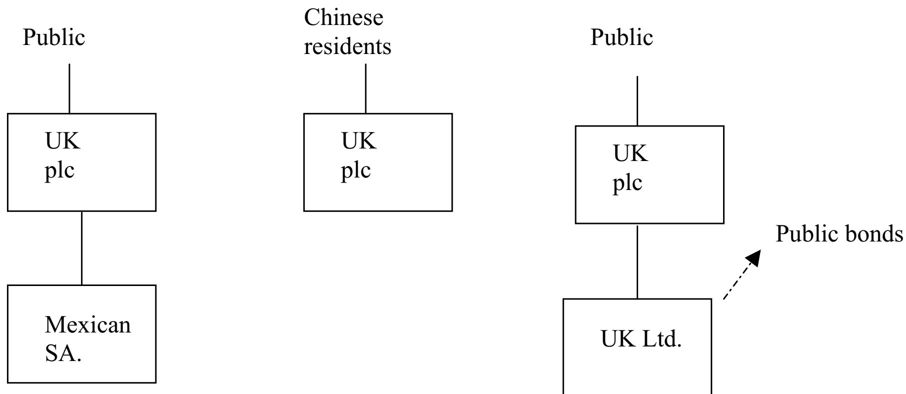
Circled area shows which entity’s income is subject to the “substantially all subject to a comprehensive foreign income tax” test under the Notice.

Shaded areas show the jurisdictions which must (or in the partnership case, may) tax the (circled) income under the Notice.

The asterix indicates the legal employer of the service provider.

Under the Report’s proposal, in each case the UK Ltd. company or true branch would be the plan sponsor (because the UK Ltd. company or branch is taxable under UK law) and its income would be evaluated under the “substantially all” test. In the branch case, the French corporation would *also* be evaluated as a plan sponsor (and its income tested under the “substantially all” test) since under French law the branch income is treated as income of the French corporation. A similar result would apply where the UK entity is a limited partnership treated as a flow-through in the UK and in France.

“Limitation on Benefits” Issues”



Mexican SA is not an “eligible” treaty resident because owned by the UK Plc.

Excluded dividends *are* treated as excluded nonresidence source income because not an eligible treaty resident.

UK plc may not be an “eligible” treaty resident because owned by Chinese residents.

Application of “active business” test uncertain.

UK Ltd. may or may not be an “eligible” treaty resident depending on base erosion test (i.e., bond interest as a percentage of gross income).