Date: October 23, 2008

To: Interested Persons

Re: New Deferred Compensation Rules May Affect US Employees of Foreign Corporations, Including Foreign Subsidiaries of US Corporations

---

New rules on deferred compensation, enacted as part of the Emergency Economic Stabilization Act of 2008 on October 3, 2008, may have a much broader scope than originally anticipated. These rules may affect, for example, the deferred compensation of US individuals employed by foreign corporations and foreign subsidiaries of US financial institutions and other nonfinancial US corporations, *even though such deferred compensation otherwise complies with the requirements of Section 409A*. The new provision, Section 457A of the Internal Revenue Code, is generally effective for deferred compensation attributable to services performed after December 31, 2008.[1]

Section 457A severely limits the circumstances under which a US taxpayer can receive deferred compensation from certain foreign corporations and other "nonqualified entities," and in some cases results in taxation at penalty rates on income that is treated as deferred. Although this legislation was aimed at deferred compensation arrangements of offshore hedge fund managers, the provision may apply to compensation paid by a fairly broad group of foreign corporations. Accordingly, while it is possible that the Treasury Department may provide guidance limiting the scope of Section 457A, both US corporations with foreign subsidiaries and foreign corporations should consider whether, in the absence of any such guidance, their US employees may be subject to Section 457A.

The following sets forth a brief description of the key elements of Section 457A and a few examples of its potential application to foreign corporations, including foreign subsidiaries of US corporations. For a more complete description of Section 457A, please see the Davis Polk memorandum entitled "Section 457A."

[1] In addition, if any deferred compensation that is attributable to services performed before 2009 has not been included in income ***before 2018***, it must be included in income in the last taxable year beginning before 2018 unless the compensation is still subject to a "substantial risk of forfeiture" at such time.

Section 457A – In General

Under Section 457A, compensation for services provided to a "***nonqualified entity***" pursuant to a "***nonqualified deferred compensation plan***" must be taken into account for tax purposes when the compensation has been earned economically and there is no "***substantial risk of forfeiture***" of the right to such compensation.

Nonqualified Entity. A "nonqualified entity" includes any foreign corporation unless substantially all of its income is either (i) subject to a comprehensive foreign income tax or (ii) treated as "effectively connected" with the conduct of a trade or business in the United States.[2] If a foreign person is eligible for the benefits of a comprehensive income tax treaty between the United States and a foreign country, a "***comprehensive foreign income tax***" means the income tax of that foreign country. Otherwise, the income tax of a foreign country will be treated as a "***comprehensive foreign income tax***" only if the foreign person can demonstrate to the satisfaction of the Treasury Department that the foreign country has a comprehensive income tax.

The definition of a "nonqualified entity" is uncertain in a number of respects. First, there is no guidance in the statute or legislative history as to what percentage of an entity's income will constitute "substantially all" of its income. Similarly, for entities that are not eligible for the benefits of a comprehensive income tax treaty between the United States and a foreign country, it is unclear what the Treasury Department will consider a "comprehensive foreign income tax" and when the entity's income will be considered to be "subject to" such tax. For example, certain jurisdictions (such as Hong Kong) contain broad exemptions from tax for certain types of income, such as capital gains; similarly, some foreign entities may benefit from "tax holidays" or similar exemptions from tax granted by a foreign jurisdiction, raising the question whether, in any year, substantially all of the entity's income will be considered to be "subject to" an otherwise comprehensive foreign income tax.[3]

---

[2] A "nonqualified entity" also includes any partnership unless substantially all of its income is allocated to persons other than (x) foreign persons that are not subject to a comprehensive foreign income tax in respect of such income and (y) tax-exempt organizations. As a result, Section 457A may also apply to US individuals employed by joint ventures or other "operating partnerships" (foreign or domestic) that are owned, in whole or in part, by foreign persons or tax-exempt organizations.

[3] Section 457A also does not specify what period or periods are to be taken into account in determining whether substantially all of an entity's income must be subject to a comprehensive foreign income tax.

Finally, the treatment of a corporation that is organized in a country that has a "territorial" system of taxation pursuant to which such country does not tax foreign source income, but which has branches and/or subsidiaries in different countries, is also unclear. While the Treasury Department may provide guidance concerning such corporations, any such guidance would likely require that the corporation's foreign source income have been subject to a comprehensive foreign income tax in the countries in which the corporation's branches and subsidiaries are located. As a consequence, it is possible that a foreign operating company with branches or subsidiaries would be treated as a "nonqualified entity" for purposes of Section 457A, even though the company itself is a resident of a jurisdiction with a comprehensive tax system and even though it qualifies for the benefits of the income tax treaty between the United States and its country of residence.

Nonqualified Deferred Compensation Plans. For purposes of Section 457A, a "***nonqualified deferred compensation plan***," is generally defined in the same manner as under Section 409A. Unlike Section 409A, however, Section 457A specifically includes as a "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, such as "stock appreciation rights" ("SARs") or "restricted stock units" ("RSUs").[4] It is possible that the Treasury Department will issue guidance that applies Section 457A to equity units of an upper-tier entity or related person, including SARs or RSUs with respect to the stock of a foreign subsidiary's parent corporation. Compensation will not be treated as deferred for purposes of Section 457A if it is paid no later than 12 months after the end of the service recipient's taxable year during which any "substantial risk of forfeiture" lapsed.[5]

Substantial Risk of Forfeiture. Under Section 457A, a right to compensation will generally be treated as subject to a "***substantial risk of forfeiture***" ***only*** if it is conditioned on the future performance of substantial services by an individual. A substantial risk of forfeiture will therefore not be considered to exist merely because the service provider's right to receive the compensation is subject to any other condition, such as the attainment of a target level of earnings. By contrast, under Section 409A, a right to compensation will also be treated as subject to a "substantial risk of forfeiture" if it is subject to the

[4] Under Section 409A, by contrast, a right to compensation based on the appreciation in value of a specified number of shares of the service recipient's stock will under certain circumstances not be treated as deferred compensation.

[5] Certain aspects of the overlapping application of Section 409A and Section 457A are not clear and will have to be addressed in Treasury regulations.

occurrence of a condition related to the purpose of the compensation and the possibility of forfeiture is substantial.[6]

Consequences of Application of Section 457A. As discussed above, deferred compensation that is subject to Section 457A must be included in income when there is no "substantial risk of forfeiture" of the rights to such compensation. If the amount of any deferred compensation is not determinable at the time that it is required to be included in income under Section 457A, the compensation will be taken into account when it becomes determinable, but the tax liability will be ***increased by an amount equal to 20% of the compensation, plus an interest charge***. For example, compensation payable pursuant to a "notional plan," in which the amount payable to the employee is determined by reference to the gain realized by an investment fund sponsored by an affiliate of the foreign employer (or other similarly variable reference investment), could be includible in the employee's income pursuant to Section 457A prior to the fund's realization of the relevant gain, and would therefore be subject to the increased tax when actually paid.

Examples of Possible Application of Section 457A to US Individuals Employed by Foreign Corporations

Example 1. Individual A, a US citizen, is employed by FS, a Country X corporation that is a subsidiary of USP, a US corporation. FS does not have any branches or subsidiaries outside of Country X. Country X does not have a tax treaty with the United States and does not have a comprehensive foreign income tax. In 2009 and later years, A participates in USP's deferred compensation plan, which has been designed to qualify under Section 409A and provides for distributions more than 12 months after the year in which income is deferred. A's rights to distributions under the plan are not conditioned on the future performance of services by A. Section 457A applies to A's deferred compensation and requires A to include the deferred compensation in income currently.

Example 2. Same facts as Example 1, except that, in 2009 and later years, A also receives SARs or RSUs with respect to USP stock. A's rights to payout of such SARs or RSUs are either not conditioned on the performance of future services by A or are so conditioned, but payout under the plan occurs more than 12 months after the year in which such substantial risk of forfeiture lapses. The Treasury Department may issue guidance to the effect that such SARs or RSUs

[6] Section 457A grants the Treasury Department authority 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***" that is held by an investment fund or similar entity.

are part of a nonqualified deferred compensation plan for purposes of Section 457A and that A's payouts under the plan are subject to the increased rate of tax and interest charge described above.

Example 3. Same facts as Example 1, except that (i) FS is eligible for the benefits of a comprehensive income tax treaty between Country X and the United States, but (ii) FS is the beneficiary of a "tax holiday" granted by Country X pursuant to which FS is entitled to an exemption from, or a reduced rate of, Country X income tax for a specified number of years. It is unclear whether FS's income will be considered to be "subject to" a comprehensive foreign income tax, and thus whether FS will be a "nonqualified entity" for purposes of Section 457A.

Example 4. Same facts as Example 1, except that (i) FS is eligible for the benefits of a comprehensive income tax treaty between Country X and the United States, (ii) Country X has a "territorial" system of taxation pursuant to which foreign source income is not generally subject to Country X income tax, and (iii) FS has a branch or subsidiary in Country Y, which does not have a tax treaty with the United States and does not have a comprehensive foreign income tax. A sufficient portion of FS's income is earned, directly or indirectly, from its branch or subsidiary in Country Y such that less than substantially all of FS's income is subject to Country X income tax (for example, FS is a holding company or is an operating company with substantial branch or subsidiary operations outside of Country X). The Treasury Department may issue guidance to the effect that FS is a "nonqualified entity," with the result that Section 457A will apply to A's deferred compensation.

Example 5. Same facts as Example 4, except that, rather than being a subsidiary of USP, FS is a publicly traded Country X corporation. The Treasury Department may issue guidance to the effect that FS is a "nonqualified entity," with the result that Section 457A will apply to A's deferred compensation.

If you have questions regarding this memorandum, please call your regular Davis Polk contact.