



**TAX UPDATE**

**The Tax Practice of Sidley Austin LLP**

Our Tax Practice provides legal services in transactions, planning and controversy related to United States federal, state and local and United Kingdom tax laws. Our lawyers work closely with our clients and with lawyers in the firm's other practice groups to develop timely, cost-effective tax strategies and to identify and solve potential tax-related problems.

**For more information regarding these topics, please contact your regular Sidley lawyer. If you would like to speak directly with one of our tax lawyers, please contact:**

**Bridget O'Neill**      **Jon Brose**  
 312.853.2205      212.839.5958  
 boneill@sidley.com      jbrose@sidley.com

**Kevin Pryor**      **Bradley Martinson**  
 312.853.7366      312.853.7120  
 kpryor@sidley.com      bmartinson@sidley.com

**Paul Wysocki**      **John Schaff**  
 212.839.5303      312.853.7522  
 pwysocki@sidley.com      jschaff@sidley.com

**To receive future copies of the Tax Update via email, please send your name, company or firm name and email address to Amy Hinkler at ahinkler@sidley.com.**

**Interim Guidance on Current Taxation of Deferred Compensation from Certain Tax Indifferent Parties**

On January 8, 2009, the Internal Revenue Service released Notice 2009-8, which provides interim guidance on the current taxation of deferred compensation from certain tax indifferent parties as provided in recently enacted Section 457A of the Internal Revenue Code. Under Section 457A, U.S. investment managers of offshore investment funds are no longer entitled to defer compensation for services performed after December 31, 2008. Notice 2009-8 provides temporary guidance on the application of Section 457A until the Internal Revenue Service and the Treasury Department issue further guidance.

**Current Law**

Under Section 457A, a service provider is required to include in income all compensation payable by a nonqualified foreign entity pursuant to a nonqualified deferred compensation plan at the time that entitlement to such compensation is not subject to a substantial risk of forfeiture. Nonqualified foreign entities include foreign corporations unless they are subject to a comprehensive foreign income tax or substantially all of their income is subject to U.S. federal income tax and certain partnerships. Offshore investment funds will be treated as nonqualified foreign entities (because their income is not generally subject to foreign or U.S. income tax), and investment managers will not be entitled to defer the compensation payable by offshore investment funds.

For purposes of Section 457A, the rights of a person to compensation are subject to a substantial risk of forfeiture only if such person's rights are conditioned upon the future performance of substantial services by such person. Deferred compensation does not include compensation that is paid within 12 months after the end of the service recipient's taxable year during which the compensation became no longer subject to a substantial risk of forfeiture.

If the amount of deferred compensation is not determinable at the time the right to such deferred compensation is no longer subject to a substantial risk of forfeiture, the deferred compensation will not be included in the service provider's income until the amount is determinable. Once the amount of deferred compensation is determinable, it is then includible in income under Section 457A. When the deferred compensation

*Attorney Advertising - For purposes of compliance with New York State Bar rules, our headquarters are Sidley Austin LLP, 787 Seventh Avenue, New York, NY 10019, 212.839.5300 and One South Dearborn, Chicago, IL 60603, 312.853.7000. Prior results do not guarantee a similar outcome.*

is included in income, the tax on such income will be increased by 20% of the amount of the deferred compensation plus an interest charge.<sup>1</sup>

To the extent that a service provider has outstanding deferred amounts payable by a nonqualified entity that are attributable to periods ending on or before December 31, 2008, such deferred amounts generally must be included in income no later than 2017.

### **Notice 2009-8**

Several highlights of Notice 2009-8 that may be of interest to investment managers are discussed below.

#### *Method of Accounting*

Notice 2009-8 clarifies that service providers are subject to Section 457A regardless of whether they use the cash or accrual method of accounting for gross income.

#### *Foreign Corporations*

A foreign corporation will be considered to be subject to a comprehensive foreign income tax if it is eligible under the limitation of benefits provision of a comprehensive income tax treaty. Notice 2009-8 provides that the income tax treaties with Bermuda and the Netherlands do not qualify as comprehensive income tax treaties under Section 457A. The notice further provides that even if a foreign corporation is eligible for the limitation of benefits provision of an income tax treaty with the United States, a foreign corporation will nevertheless not be treated as subject to a comprehensive foreign income tax if the corporation's income from sources outside its country of residence is excluded from taxation by its country of residence and more than 20% of the corporation's income consists of such income.

---

<sup>1</sup> Section 457A gives the Internal Revenue Service the authority to promulgate regulations providing that compensation determined solely by reference to the amount of gain recognized on the disposition of a single investment asset remains subject to a substantial risk of forfeiture until the date of such disposition. The effect of any such regulations would be to eliminate the 20% tax and interest charge that would otherwise apply to such compensation.

#### *Partnerships*

Deferred compensation received from a partnership will not be subject to Section 457A if substantially all of the partnership's income is allocated to persons ("Eligible Persons") other than (a) foreign persons who are not subject to U.S. income tax or to a comprehensive foreign income tax on such income and (b) domestic tax-exempt organizations. Notice 2009-8 provides that at least 80 percent of a partnership's gross income must be allocated to Eligible Persons to avoid treatment as a nonqualified entity. Notice 2009-8 further provides that the Internal Revenue Service may look through the partnership's partners to their direct or indirect owners and to the beneficiaries of trusts and estates for purposes of this test.

#### *Amount Includible in Income*

Notice 2009-8 specifies that earnings on deferred compensation are subject to Section 457A and will be included in income when the right to earnings is no longer subject to a substantial risk of forfeiture. In addition, the notice provides that once an amount of deferred compensation is included in income under Section 457A, the service provider will not have to include such amount in income when actually received. If the right to an amount previously included in income is permanently lost, the service provider is entitled to a loss determined using the rules under Section 409A.

#### *Amounts not Determinable*

Notice 2009-8 provides that an amount is not determinable under Section 457A (and, thus, potentially subject to the 20% additional tax and interest charge described above) if the amount payable in a future year is dependent upon factors that are not determinable as of the end of the service provider's taxable year. Thus, where an investment manager's compensation depends on the amount that would be realized upon the disposition of illiquid assets, such manager's compensation would be treated as not determinable under Section 457A.

### *Effective Date*

Generally, Section 457A applies only to compensation attributable to services performed on or after January 1, 2009. Notice 2009-8 includes a series of guidelines and examples to be used in determining whether compensation is attributable, in whole or in part, to services performed before January 1, 2009. Among other things, these guidelines and examples establish the following:

- To the extent that a service provider has a legally binding right to compensation as of December 31, 2008, and the right to such compensation is not conditioned on the performance of future services, such compensation (and any reasonable earnings thereon the right to which is not conditioned on the performance of future services) will not be attributable to services performed after December 31, 2008.
- To the extent that a service provider has a legally binding right to compensation as of December 31, 2008, and the right to such compensation is conditioned on the performance of future services, the amount of such compensation that is attributable to services performed after December 31, 2008 generally will be determined by prorating the compensation over the period during which the service provider is required to perform services.

### *Coordination with Section 409A*

In general, compensation is not considered to be deferred under Section 409A if it is received within two and a half months after the service provider's taxable year in which the compensation ceases to be subject to a substantial risk of forfeiture. Notice 2009-8 provides that inclusions in income under Section 457A will generally qualify as payments for

purposes of Section 409A. Thus, Section 409A generally will not apply to deferred compensation that is included in income under Section 457A.

The Internal Revenue Service will issue further guidance on timing issues that may arise under Section 409A, such as when a deferred amount becomes subject to Section 457A in a future year or ceases to be subject to Section 457A in a future year. Until such guidance is issued, Notice 2009-8 provides that the payment of a deferred amount during a service provider's taxable year at the time such amount becomes includible in income under Section 457A will not constitute an impermissible acceleration under Section 409A.

### *Illiquid Investments*

The notice concludes with a request for comments on all of the issues addressed in the notice, and in particular, on the exception to the definition of a substantial risk of forfeiture that may be provided by regulations under Section 457A with respect to single investment assets. The scope of this exception, if provided, will be of particular importance to investment funds with substantial illiquid investments.

### *Transition Relief*

To the extent that an investment manager has outstanding deferred amounts attributable to services performed before January 1, 2009, and such deferred amounts are currently scheduled to be paid after 2017, Notice 2009-8 provides that a change in the time and form of payment to conform the date of distribution to the date the amount is required to be included in income under Section 457A will not be treated as an impermissible acceleration of such deferred amounts under Section 409A so long as the change in time and form of payment is established in writing and effective on or before December 31, 2011.

***This Tax Update has been prepared by Sidley Austin LLP for informational purposes only and does not constitute legal advice. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this Tax Update without seeking advice from professional advisers. Furthermore, this Tax Update was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding any U.S. federal, state or local tax penalties that may be imposed on such person.***

BEIJING BRUSSELS CHICAGO DALLAS FRANKFURT GENEVA HONG KONG LONDON LOS ANGELES NEW YORK SAN FRANCISCO SHANGHAI SINGAPORE SYDNEY TOKYO WASHINGTON, D.C.

[www.sidley.com](http://www.sidley.com)

Sidley Austin LLP, a Delaware limited liability partnership which operates at the firm's offices other than Chicago, London, Hong Kong, and Sydney, is affiliated with other partnerships, including Sidley Austin LLP, an Illinois limited liability partnership (Chicago); Sidley Austin LLP, a separate Delaware limited liability partnership (London); Sidley Austin, a New York general partnership (Hong Kong); Sidley Austin, a Delaware general partnership of registered foreign lawyers restricted to practicing foreign law (Sydney); and Sidley Austin Nishikawa Foreign Law Joint Enterprise (Tokyo). The affiliated partnerships are referred to herein collectively as Sidley Austin, Sidley, or the firm.

SIDLEY AUSTIN LLP  
**SIDLEY**