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October 5, 2009

Mr. Michael Mundaca
Acting Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Report on Rules Governing Nonqualified Deferred Compensation Under Section 457A

Dear Sirs:

We write to submit a report commenting on Section 457A of the Internal Revenue Code. Section 457A generally requires the inclusion in income of compensation deferred under a "nonqualified deferred compensation plan" of a "nonqualified entity," such as deferred compensation paid by an employer organized in a tax haven, when such amounts are no longer subject to a "substantial risk of forfeiture."

Section 457A was enacted in 2008, and applies to deferred compensation attributable to services performed starting January 1, 2009. It appears that Section 457A is based generally on the concept that if a service recipient (typically an employer) is tax-indifferent, especially in respect of whether there is a tax deduction that would be deferred by virtue of the deferral of compensation, it may be more likely that there

will be inappropriate deferrals of compensation paid to service providers (typically employees). After the statute was enacted, it became clear that its reach extended beyond the initially intended targets – generally believed to be investment funds – reaching both to certain types of offshore entities other than investment funds, and even to certain types of domestic entities.

Earlier this year, the Department of the Treasury and the Internal Revenue Service issued Notice 2009-8, 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.

As described in more detail in the report, we provide detailed comments on specific areas where we believe Treasury and the Service should issue guidance, and offer recommendations relating to such guidance. In addition, we believe that certain changes to the statute should be made by Congress to make it more administrable and, we believe, consistent with the underlying statutory purposes. A list of our recommendations is attached to this letter. (We are also sending the report and a similar letter to Congress.) The remainder of this letter sets forth certain principles that underlie our recommendations.

Scope. Because Section 457A may apply to many "real" multinational operating companies, 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. Practical interpretive and compliance difficulties are exacerbated by the multidisciplinary nature of Section 457A, and its implications for benefits, international and partnership issues. It is worth noting that government officials and others are now encouraging deferral of compensation, in order 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 substantive regulatory and other non-tax considerations call for deferral. Further, 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 are done looking to foreign law rather than U.S. tax principles including, in particular, the "check the box" rules.

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). 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. A related question is what should be the default position where it is not possible to determine all of the relevant facts. 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 company, we do not think the rules should in effect make nonqualified entity status the default presumption in the absence of contrary facts.

Identifying tax-indifferent employers. We believe 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. 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.

We also believe that 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, since Section 457A borrows concepts and defined terms from Section 409A (which prevents acceleration of compensation that has been deferred), which also deals with deferred compensation, the two sections should be harmonized, except where differences in statutory language or statutory purpose call for different rules.

We appreciate your consideration of our comments. Please let us know if you would like to discuss these matters further or if we can assist you in any other way.

Respectfully submitted,

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Chair

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Recommendations for Changes to Rules Governing Nonqualified Deferred Compensation Under Section 457A

I. Recommendations for Statutory Change

Relevance of foreign law. 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. Because 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, we recommend that, if necessary, Section 457A should be amended to place primary significance on whether an entity or investor therein benefits from compensation deductions, determined under applicable foreign law.

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

ECI. Section 457A(d)(4) provides that Section 457A does not apply to compensation deductible from income of a foreign corporation that is subject to U.S. net income taxation. Congress should extend this rule so that it applies to partnerships as well as foreign corporations.

Death and disability. 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. As with several of the other changes recommended above, this would be necessary only if Treasury and the Service believe that they do not have authority to provide regulations to this effect.

Investment asset exception. The investment asset exception as drafted will be of no relevance to most or possibly all hedge fund side pocket arrangements. Accordingly, we recommend that the exception 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. 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.

II. 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 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.

Stock appreciation rights. We recommend that the rules for stock-settled SARs be expanded by including SARs on equity of non-corporate entities such as partnerships and 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.

"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 person who are not U.S. taxpayers be excluded from the definition of "nonqualified deferred compensation" for purposes of Section 457A.

"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 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.

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.

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.

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.

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.

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. 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. If the taxable years of the service provider and service 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.

"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. 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.

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 to itemize deductions or are subject to the alternative minimum tax.

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. Consistent with this recommendation, it should not matter whether the entity is a reverse hybrid or a branch. 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.

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 compensation payment to the service provider. 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. 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.

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. 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.

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. 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.

"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.

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. (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. 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. We include in our "Detailed Report" a recommended list of additional exceptions to the calculation of the excluded amount.

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. 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.

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.

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. Under a three-tier system similar to that proposed for foreign entities, certain service providers should be able to rely in good faith on this limited information reporting, and should be able to make certain simplifying 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.

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.

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.

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. Section 736 payments should also be excluded from Section 457A, regardless of whether or not they are exempt from SECA tax.

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.

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.

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).

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. In particular:

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

"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.

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 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.

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.

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).

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.

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.