Caplin&Drysdale

taxAlert

www.caplindrysdale.com

May 2007

Final 409A Regulations Provide Some Clarification and Liberalization of Proposed Regulations

On April 17, 2007, the Department of Treasury issued final regulations under Code section 409A, relating to nonqualified deferred compensation, which become effective on January 1, 2008. Like the proposed regulations, the final regulations are long, complex, highly nuanced, and formalistic. They do, however, provide some liberalization and clarification of the regulations that were proposed in October 2005.

Background and General Principles

Congress enacted section 409A as part of the American Jobs Creation Act of 2004, in part as a response to the Enron debacle. Section 409A superimposes additional, black letter requirements on the cash method principles (i.e., constructive receipt and economic benefit) that had previously governed the income tax treatment of nonqualified deferred compensation. The statute generally requires that elections to defer compensation be made prior to the year in which compensation is earned, allows deferred compensation to be paid only at pre-established times and for certain events, prohibits accelerated payments, and limits re-deferral for payment at a later time.

However, Congress provided very little guidance on what "nonqualified deferred compensation" means for purposes of section 409A, and more than half of the final regulations is devoted to defining compensation arrangements that are and are not covered by section 409A, as well as identifying various sub-species of covered arrangements; this accounts for much of the complexity and nuance. Seemingly simple questions, like whether stock options or severance arrangements are covered by section 490A, are subject to detailed rules and exceptions and exceptions to exceptions.

All of this matters because Congress has made the stakes extraordinarily high. If a nonqualified deferred compensation plan covered by section 409A fails to comply with the requirements of section 409A, whether in form or in operation, the employee is taxable on the value of the deferred compensation to the extent of his vested rights, whether or not the deferred compensation has been received. In addition, he or she is subject to a penalty (additional tax) equal to 20% of the value of the vested, noncompliant deferred compensation, plus an interest charge at the deficiency rate plus 1%. These punitive consequences apply to any act of noncompliance, no matter how minimal, benign, or inadvertent. The IRS has been given no authority to absolve for good cause or harmless error, and employers are legally compelled to report events of noncompliance on Form W-2.

The following highlights several key provisions of the final regulations, focusing on those areas where important changes from the proposed regulations have been made.

Stock Options and Stock Appreciation Rights

Stock options and stock appreciation rights are generally exempt from section 409A (not treated as non-qualified deferred compensation plans) if (i) the stock is "service recipient stock," (ii) the strike price is never less than the fair market value of the stock on the date of grant, and (iii) the option contains no additional deferral feature. The final regulations liberalize each of these requirements to some degree.

Under the final regulations, stock qualifies as service recipient stock if it is common stock of the corporation by which the employee is employed or any corporation in an upward chain of corporations that has at least a 50% (20% if there are legitimate business criteria) ownership interest in the employer corporation. With respect to the strike price requirement, the final regulations continue to narrowly restrict the use of average trading prices for publicly traded stock, but in the case of nonpublicly traded stock (e.g., of start-up companies), the valuation requirements have been liberalized. Lastly, and significantly for many companies, the final

continued on next page

regulations allow the section 409A exemption to be retained upon the extension of stock options, provided the extension does not extend beyond the earlier of the original maximum term or 10 years from the date of the original grant; also, re-pricing of "underwater" options to current market value is treated as a re-issuance, not a prohibited reduction of the strike price or additional deferral feature.

Termination of Employment

If deferred compensation is payable upon termination of employment, which is one of the permissible payment triggers under section 409A, it is essential to know when an employee has terminated, lest there be a prohibited delay or acceleration of payment. Questions commonly arise when employees are kept on the payroll with reduced or minimal duties or are granted terminal leaves. The final regulations impose a presumption of termination of employment if an employee's actual services have been permanently reduced by 80% (compared with the preceding 36 months), and impose a presumption that employment has not terminated if an employee's services have not been reduced by more than 50%. Various factors may be adduced to rebut the presumption of termination.

Tax Gross-Up Payments

Particularly because of the risk of punitive employee taxation under section 409A attributable to employer foot-faults, it is important to know whether and how section 409A applies to payments made by employers to reimburse employees for the resulting tax liabilities. Similar issues arise with respect to tax reimbursements attributable to the golden parachute rules of section 280G. The final regulations provide that a right to a tax gross-up payment constitutes deferred compensation covered by section 409A, but that such payments are section 409A compliant if made by the end of the year following the year in which the employee's tax liability is satisfied.

Post-Termination Reimbursements and Fringe Benefits

The final regulations contain a series of provisions relating to non-cash benefits and reimbursement arrangements for former employees. Although wading through the various rules is a chore, they will allow most such benefits to be continued without violation of section 409A. First, benefits that are excluded from gross income (such as insured post-retirement health benefits) are generally exempt from section 409A. Second, reimbursement or provision of benefits such as outplacement services and moving expenses are exempt if reimbursed by the end of the third year following termination or provided by the end of the second year. Third, indemnifications for expenses or damages for claims against the employee for his actions as an employee are exempt. Other fringe benefits (such as reimbursement of country club dues or the right to use corporate aircraft following termination of employment) are not exempt, but are section 409A compliant if the former employee does not have any right to convert the benefits to cash for other uses, and reimbursements or benefits provided in one year do not affect the amount or level of reimbursements or benefits available in any other year.

The final regulations do not clarify, however, how the six-month delayed payment rule for specified employees applies to such fringe benefits and reimbursements.

Document Requirements

The final regulations maintain the requirement that a nonqualified deferred compensation plan covered by section 409A must be in writing and continue to provide that a written plan provision that violates the requirements of section 409A (even if it never comes into play) constitutes a section 409A violation, with all the attendant tax sanctions. Since existing plan documents must be amended to conform to the final regulations by December 31, 2007, and since there is no provision allowing subsequent repairs to defective documents that would avoid a section 409A violation with respect to then existing deferred compensation rights, getting the plan document right must be taken seriously. However, the final regulations reflect some recognition of the absurdity of this regime by slightly limiting the provisions that must be included in a written plan. On the other hand, the final regulations provide that a "savings clause" in a plan document that purports to override any provision inconsistent with the requirements of section 409A will be disregarded.

More section 409A guidance is to come, though it is unclear when. Not yet addressed are valuation rules for unpaid deferred compensation rights, the statutory requirement that the amount of compliant deferred compensation rights be reported annually on Form W-2 or 1099, and the prohibitions on offshore and certain other funding techniques. But those unaddressed issues provide little respite from the formidable compliance challenges that the final regulations pose for employers, employees, and tax practitioners.

continued on next page

For more information, please contact Richard Skillman at 202-862-5034 or rws@capdale.com.

New Proposed Foreign Tax Credit Regulations Focus on Structured Passive Investment Arrangements

On March 29, 2007, the Treasury Department published new proposed regulations dealing with foreign tax credits. Following on the heels of earlier proposed regulations (issued in August of last year), the proposed regulations represent an attempt by the government to craft technical rules that will prevent US taxpayers from arbitraging the difference between US and foreign tax laws to claim foreign tax credits that may also provide a benefit to a foreign taxpayer under its own tax regime.

The first notable aspect of the proposed regulations is that they depart from the traditional notion that a tax will be treated as "compulsory" and, hence, creditable, even when it results from a structure that is designed to maximize rather than minimize foreign taxes. While the scope of the present rule has never been entirely clear, it provides that a taxpayer "is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax." Treas. Reg. § 1.901-2(e)(5)(i). The proposed regulations provide an exception to this general rule by requiring that certain payments be treated as noncompulsory if they arise from certain structured passive investment arrangements which possess six characteristics described in the regulations. Prop. Reg. 1.901-2(e)(5)(iv).

General Approach of Proposed Regulations

The proposed regulations are remarkably intricate in their approach. There are six conditions that must be satisfied, an additional seven terms that are defined, and special rules that are created for "holding companies" that have substantially all of their assets in the form of lower-tier entities. Without attempting to recapitulate the regulations in all of their complexity, the broad outline of the structures to which they will relate is as follows:

1. The transaction is structured through the use of an entity (which for this purpose includes a legal entity that is otherwise disregarded for U.S. tax purposes);
2. A U.S. person and an unrelated foreign person (the "counterparty") each have substantial investments in the entity;
3. Substantially all the assets of the entity are passive assets, which term generally does not include operating businesses or substantial voting equity investments (other than certain preferred stock) in subsidiaries that primarily consist of operating businesses;
4. The entity pays foreign taxes in an amount which exceeds any withholding tax that would apply to a direct investment by the U.S. person in the underlying assets;
5. Some element of the transaction (e.g., the classification of an instrument as debt or equity, the classification of an entity as fiscally transparent or non-transparent, or the ownership of an interest in the entity) is treated differently for U.S. tax purposes and foreign tax purposes; and
6. The counterparty or a person related to the counterparty claims some form of benefit on account of the payment of tax by the entity.

Controversial Aspects of Proposed Regulations

Aside from their complexity, several aspects of the proposed regulations are worthy of specific comment. It is, for example, hard to understand why the government has chosen to limit these regulations to transactions involving unrelated foreign "counterparties." The government would certainly be aware that it is easier to structure internal transactions than transactions with unrelated parties. Thus, it appears that there must have been an assumption that these kinds of transactions simply could not accomplish the desired results if engaged in between related parties. Yet this thought seems demonstrably false. First of all, one need only consider the situation of a foreign-parented U.S. corporation to see how it could be possible to double-dip foreign tax credits without involving an unrelated counterparty. And even in the context of U.S. parented multinationals, one can envision transactions in which internal structures otherwise similar to those described in the proposed regulations would be used to separate taxes from the related income (one of the precise concerns that the regulations issued in August of last year were trying to address).

Additionally, it is curious that the government has chosen to attack this kind of arbitrage (the benefit for the payment of a foreign tax being claimed both in the United States and in a foreign country) via the notion that the tax is not compulsory. The critical element which impacts the U.S. fisc is not so much the structured element of the transaction but rather the fact that a foreign tax credit (a provision of the Internal Revenue Code meant to

continued on last page

prevent double taxation) is being granted in a situation where the cost of the foreign tax is (at least arguably) borne by another person. Against this backdrop, one might expect that the government would have addressed the problem via an interpretation or expansion of the existing subsidy rules (currently set forth in Treas. Reg. § 1.901-2(e)(3)) to apply in any situation where the laws of the foreign country whose taxes are in issue will give a tax benefit to another party on account of taxes paid by a particular entity. Under the proposed regulations, however, this is only one of six conditions that must be met to render the tax non-creditable.

Another interesting aspect of the proposed regulations is that they apply regardless of where the foreign counterparty claims a foreign tax benefit. Thus if a U.S. company and a French counterparty form an SPV in Italy that pays Italian taxes, the regulation can still apply if the French company gets a tax benefit in France based on the payment of Italian taxes. In this regard the proposed regulations are broader than what would have resulted if the government had attacked the problem by expanding the subsidy rules of the existing regulations as described above – in which case a tax could be disallowed only to the extent that it provided a tax benefit under rules of the same country to which the tax was initially paid. This discrepancy poses an interesting philosophical question. On the one hand it is true that highly structured deals such as those that the government is targeting with these proposed regulations drain the U.S. fisc and seem to provide little tangible economic benefit to the world at large. On the other hand, it is a drastic change in U.S. tax policy to allow treatment of an amount that would otherwise be creditable as a tax payment to one foreign country (Italy, in the example above) to depend upon the consequences of a transaction in another foreign country (France, in the example above). In general, U.S. tax consequences are entirely a question of domestic law. It is only in very specific circumstances (such as the technical taxpayer rules of Treas. Reg. § 1.901-2(f) that were revised last August) that the U.S. even looks to the tax laws of the foreign country where a transaction takes place or an entity is incorporated in determining the U.S. tax consequences of the transaction.

The closest analogue to these proposed regulations appears to be the "branch rules" of Treas. Reg. § 1.954-3(c) (which effectively compares the tax rate in a company's home country to the tax rate in a country where it operates as a branch). In that case, however, the relevance of the third country for U.S. tax purposes seems easier to articulate (because a primary purpose of subpart F is to impose U.S. tax on mobile income that is escaping foreign taxation). In addition, the application of subpart F rules generally do not implicate any provisions of a U.S. tax treaty, while most such treaties do include a provisions regarding relief from double taxation under which the U.S. is obligated to give a credit for taxes paid to the treaty partner. A regulation which purports to disallow such credits based on in a third country certainly raises novel questions of treaty compliance.

Given the complexity of these proposed regulations and the controversy that they are sure to stir, it appears likely that substantial revisions may be made before the regulations are adopted as final. Thus, the final chapter on these issues is clearly yet to be written.

For more information, please contact Seth Green at 202-862-7849 or smg@capdale.com.

Independent and In-House Tax Professionals Take Note: The IRS Office of Professional Responsibility Can Now Impose Monetary Penalties For Misconduct

On April, 23, 2007, the Internal Revenue Service issued Notice 2007-39 ("the Notice"), which provides guidance to the IRS's Office of Professional Responsibility ("OPR") in exercising its authority to impose monetary penalties for practitioner misconduct. This authority is granted by Section 822 of the American Jobs Creation Act of 2004 ("AJCA") and is codified in 31 U.S.C. § 330. The Notice specifies that the monetary penalties may be imposed only with respect to prohibited conduct that occurs after October 22, 2004, the date of enactment of the AJCA.

The monetary penalties supplement the statutory sanctions against practitioner misconduct already available to OPR, in the form of reprimand, public censure, suspension or disbarment. The Notice clarifies that the monetary penalties are not a "bargaining point" which a practitioner may offer to avoid these sanctions. Nevertheless, in appropriate cases, OPR may choose to impose monetary penalties in lieu of sanctions. Additionally, the Notice states that the monetary penalties may be imposed upon the individual whose misconduct is at issue as well as the firm or company, or other related entity, that employs or is associated with the individual --- provided that the employer, firm or entity knew, or reasonably should have known, of the conduct giving rise to the penalty.

Penalties Apply to In-house Tax Advisors

Before launching into a brief discussion of the penalties, it is important to note OPR's position on the scope of its authority over in-house tax advisors. We understand that OPR interprets the AJCA as extending its jurisdiction to impose monetary penalties to tax counsel, tax directors and other in-house tax advisors who render written tax "opinions" to, or for the benefit of, their employer, regardless of whether these individuals actually practice before the IRS. This is different from OPR's sanctions authority, which has historically been limited to those tax practitioners, whether independent or in-house, who practice before the IRS, for example by filing a Form 2848 to represent a taxpayer (including an employer) in a tax examination.

Measure of Monetary Penalties

Under the 31 U.S.C. § 330(b), the aggregate monetary penalties cannot exceed the gross income derived (or to be derived) from the prohibited conduct giving rise to the penalties. In the event that a larger engagement began on or before October 22, 2004, the "gross income derived (or to be derived)" will be calculated, on a pro rata basis, to exclude amounts attributable to conduct occurring on or before October 22, 2004.

OPR may impose monetary penalties for a single act of prohibited conduct or for a pattern of misconduct. The aggregate amount of the monetary penalty (or penalties) imposed by OPR for any prohibited conduct may not exceed the collective gross income derived by the practitioner and the employer, firm, or other entity in connection with such prohibited conduct. If a single act of prohibited conduct giving rise to a monetary penalty is an integral part of a larger engagement, the amount of the penalty will be limited by the gross income derived (or to be derived) from the larger engagement. In determining the amount of the monetary penalty (or penalties), OPR will consider amounts that the practitioner, employer, firm, or other entity could reasonably expect to realize, irrespective of whether the amounts have actually been received.

Factors OPR Will Consider

The Notice explains that, mitigating factors will be considered in determining the penalty and may include whether the practitioner, employer, firm, or other entity took prompt action to correct the non-compliance after the prohibited conduct was discovered; promptly ceased engaging in the prohibited conduct; attempted to rectify any harm caused by the prohibited conduct; or undertook measures to ensure that the prohibited conduct would not occur again in the future. OPR will not impose monetary penalties in cases of minor technical violations, when there is little or no injury to a client, the public, or tax administration, and there is little likelihood of repeated similar misconduct. However, the Notice does not define or give examples of what it means by a "minor technical violation" or any of these other mitigating circumstances. The Notice does, however, point out that the IRS may issue additional guidance regarding the application of monetary penalties, including, but not limited to, the factors OPR should consider when evaluating all the facts and circumstances of a particular case. The IRS has requested comments with regard to the factors to be considered when imposing a monetary penalty.

OPR has yet to publish any guidelines pertaining to the sanctions that it may impose under Circular 230. In fact, the considerations that underlie a decision by OPR to sanction a practitioner are somewhat of a mystery to the tax community. While the Notice clarifies certain issues arising under the new monetary penalty regime, here, as well, there is room for further clarification.

The new monetary penalty regime is a noteworthy addition to OPR's arsenal of enforcement tools. It serves to remind tax professionals that the IRS and Congress are serious about cracking down on misconduct in the tax practice area, in the case of both private practitioners and practitioners employed in the corporate world. Developments in this area should be monitored closely.

For more information, please contact Kevin Thorn at 202-862-5076 or ket@capdale.com.

continued on last page

Major U.S. Withholding Tax Enforcement Initiative

The Internal Revenue Service has announced an aggressive withholding tax enforcement initiative targeting financial institutions with operations in the United States. The IRS will eventually conduct several hundred examinations of banks, broker-dealers, and other financial services firms with customers who have claimed foreign status in order to reduce or eliminate U.S. withholding tax on depository interest, dividend distributions, and the proceeds from the sale of securities.

According to the IRS, the examinations will focus on financial institutions that did not participate in the IRS' *Section 1441 Voluntary Compliance Program*. That program, which closed last summer, allowed a financial institution to self-assess whether it complied with a complex set of regulations governing the documentation of foreign persons. The participants were able to correct any noted deficiencies and avoid paying U.S. withholding tax and associated penalties that would otherwise have been assessed if the deficiencies had been detected during an IRS examination.

Based on our experience advising clients on these withholding issues, it is evident that the current IRS examination teams are strictly interpreting the governing regulations. We recommend that any financial institution that did not participate in the *Section 1441 Voluntary Compliance Program* consider a third-party compliance review at this time. A careful analysis of account opening policies and procedures, foreign status recertification requirements and a review of the documentation of non-resident alien and foreign entity accounts could significantly reduce potential exposure. Consultation with an attorney experienced with the intricacies of the IRS withholding examination process is advisable if you are notified that you have been selected for an examination.

For questions concerning the IRS withholding tax initiative or other U.S. income tax withholding matters, please contact James Mastracchio at 202-862-8859 or jnm@capdale.com.

Caplin & Drysdale helps clients plan and evaluate tax-related transactions. The firm's more than 40 tax lawyers have been designing and reviewing tax strategies for companies, organizations, and individuals throughout the United States and around the world since the firm was founded in Washington, D.C., by former IRS Commissioner Mortimer Caplin 40 years ago.

The articles appearing in this **taxAlert** do not constitute legal advice or opinions. Such advice and opinion are provided only upon engagement with respect to specific factual situations.

For more information on the issues discussed in this **taxAlert** or on Caplin & Drysdale, please contact the authors or visit our website (www.caplindrysdale.com).