

## EXECUTIVE COMPENSATION & EMPLOYEE BENEFITS, TAX TRANSACTIONS UPDATE

### Proposed Deferred Compensation Restrictions for Offshore Entities

*June 3, 2008*

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Recently proposed federal legislation would, if enacted, dramatically limit the ability of certain offshore entities to provide nonqualified deferred compensation to US taxpayers. The restrictions imposed by the bill (referred to in this memorandum as the “Deferred Compensation Restrictions”) would require that such compensation be includible in the US taxpayer’s income at the time it becomes vested. (Under current rules, recognition would be deferred to the date of actual payment, subject to the requirements of tax code section 409A and general principles of constructive receipt.)

**Nonqualified Entities.** Generally, the Deferred Compensation Restrictions would apply to an entity (referred to as a “Nonqualified Entity”) that would not benefit from a US or foreign income tax deduction, such as (i) a foreign corporation unless substantially all of its income is taxed by the United States as income from a US trade or business or is subject to a comprehensive foreign income tax, and (ii) any partnership if a substantial portion of its income is allocated to either foreign persons not subject to a comprehensive foreign income tax or to organizations exempt

from US tax. Nonqualified Entities would generally include investment funds and operating businesses located in jurisdictions not subject to US or foreign income tax. For purposes of identifying Nonqualified Entities, the House Report indicates that the IRS should issue regulations providing for the aggregation of affiliated entities. The report provides an example of deferred compensation paid to an employee by an employer subject to US tax, where that employer is a subsidiary of a foreign parent, and a deduction for the compensation would be available to the subsidiary. The example concludes that the subsidiary should not be treated as a Nonqualified Entity because it is subject to the US timing rule for the deduction of the compensation.

**Amounts Subject To Restrictions.** The restrictions would apply to nonqualified deferred compensation, which is compensation for services paid in a year after the year in which the service provider obtains a legally binding right to the compensation. However, the restrictions would not apply to compensation paid within the 12 month period after the year in which vesting occurs. An amount will be treated as vested when

it is no longer subject to a substantial risk of forfeiture. The restrictions provide that amounts will be subject to a substantial risk of forfeiture only if they are contingent on the future performance of substantial services. (Note that this definition is narrower than the definition of substantial risk of forfeiture used for the tax treatment of restricted stock and for the deferred compensation restrictions under tax code section 409A.)

**Single Asset Investments.** If the amount of compensation is determined solely by reference to gain recognized upon the sale of a single asset that is not actively managed by the entity that owned the asset (i.e., passive assets), the proposed legislation specifies that income inclusion would not be required until disposition of the asset. This provision is only applicable to the extent provided in regulations to be drafted.

**Non-Determinable Benefits.** If compensation vests before the amount of the compensation is determinable, it is not subject to tax. However, at the time it becomes determinable, the full amount of compensation will be taxed as ordinary income, and the amount will also be subject to a tax of 20 percent of the compensation plus interest from the time of vesting until the time of income recognition. The House Report indicates that an amount will not be treated as determinable if that amount varies depending on satisfaction of an objective condition. As an example of an arrangement under which the amount is not determinable, the report describes an arrangement under which no payment would be made if a certain threshold is not met, 100 percent would

be paid if the threshold is achieved and 200 percent would be paid if a higher threshold is achieved.

**Effective Date.** The restrictions would apply to amounts attributable to services performed after December 31, 2008. However, the restrictions also provide that amounts attributable to services performed before January 1, 2009, will be subject to tax in the last taxable year before 2018 or, if later, the year in which vesting occurs. The Deferred Compensation Restrictions also permit a charitable deduction for cash contributed to a public charity (but not to a section 509(a)(3) supporting organization) in the same taxable year that the deferred compensation is recognized as income by the taxpayer under this new special rule. The amount of the contribution is limited to no more than the amount of the recognized deferred compensation income in that taxable year, but this contribution is not subject to the 50 percent deduction limitation otherwise applicable to cash contributions.

**Status of the Bill.** The Deferred Compensation Restrictions are included in the Renewable Energy and Job Creation Act of 2008. The bill was reported out of the House Ways and Means Committee on May 20 as House Report 110-658, and passed the House on May 21 by a vote of 263-160. It immediately prompted a veto threat from the White House, and the House vote was 19 votes short of what would be needed to override the threatened veto. Nothing specific has been heard about the timing of the Senate's plans to return to its own tax extenders bill.

**Rationale for the Restrictions.** The expected tax revenue generated from the Deferred Compensation Restrictions would pay for tax relief provisions. The House Report provides the following rationale for the restrictions: Under current US tax rules, a tax deduction is not available to the service recipient (a “payor”) maintaining a nonqualified deferred compensation arrangement until the deferred compensation is included in the service provider’s income. Thus, for payors subject to US tax, the deferral of income recognition by the service provider results in a corresponding deferral of the tax benefit to the payor, ensuring that the cost of allowing the deferral is borne by the payor. This delay of a US deduction may limit a payor’s willingness to offer such deferred compensation. In contrast, a payor that is not subject to income tax imposed by the US or other jurisdiction is likely to be indifferent to the time of the deduction, and so may have no incentive to limit the use of such arrangements.

**Prior Proposals.** The Deferred Compensation Restrictions differ from legislative proposals made in 2007 with respect to certain payments

to investment managers, which would have substantially limited the availability of capital gain treatment for such payments. The current proposal accelerates the time at which income is recognized, but generally does not change the determination of whether the amount is treated as capital gain rather than as ordinary income.

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