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Legal Update
September 10, 2018

New York Tax Update: New Rules for Non-Qualified Deferred Compensation

September 17 is the deadline for filing 2017 federal partnership returns that are on extension, as many are, and so the time for filing is now upon us. Asset managers may be reporting significant amounts of deferred compensation on those returns as a result of the Grandfather Horizon Date (as defined below) with respect to Section 457A of the Internal Revenue Code (the "Code"), along with other items that will require careful thought. Because Section 457A relates to the federal tax Code, asset managers may not be thinking about the New York State ("State") and New York City ("City") tax consequences of such income inclusion required at the federal level—but that would be a mistake.

Federal tax reform recently made repatriation of foreign earnings a big issue for 2017, but the specific issue related to Section 457A arose almost a decade ago when the drafters of Section 457A selected 2017 as the tax year in which all amounts otherwise grandfathered from Section 457A must be included in income. The State and City have recently focused on this long looming deadline. Prior to the effective date of Section 457A in 2009, as money and profits accumulated in offshore funds for tax-exempt and foreign investors, and managers elected to defer payment on any compensation[1] that may have been due to them and to compound the returns tax-free, Congress thought change was necessary. It enacted Section 457A of the Internal Revenue Code, which generally prohibits the deferral of compensation by a service provider pursuant to a plan maintained by a nonqualified entity by requiring that deferred compensation under a nonqualified deferred compensation plan maintained by a nonqualified entity is generally included in gross income when there is no longer a substantial risk of forfeiture with respect to such compensation.

Section 457A became effective for deferred amounts that are attributable to services performed after December 31, 2008. An amount that would otherwise be subject to Section 457A except for the fact that the amount is attributable to services performed prior to January 1, 2009 ("Grandfathered Amount") is includible in income (to the extent not includible in income prior to 2018) in the later of (i) the last taxable year beginning before January 1, 2018, or (ii) the first taxable year in which such amount is not subject to a substantial risk of forfeiture (the applicable later date referred to as the "Grandfather Horizon Date"). Because the Grandfather Horizon Date would be 2017 for calendar year tax filers, this issue can no longer be avoided and may require income inclusion for asset managers of any amounts that would otherwise be a Grandfathered Amount. The firm previously put out a Legal Update related to Sections 409A and 457A and the grandfathering issue.[2]

However, this Legal Update does not address the federal aspects of Sections 409A and 457A and some of the strategies that may have been

available to manage the impact of federal repatriation requirements. Rather, it addresses some of the State and City implications for managers that have done business in the State and City and are reporting deferred compensation in 2017. The State and City assume, based on experience, that most managers operated through partnerships and LLCs rather than corporations, and this update reflects that focus.

The Landscape

First, a little background. The State and City both require returns from partnerships, LLCs, S corporations and other companies that file, but do not pay tax, at the federal level.

The State returns for partnerships and LLCs (much like the IRS Form 1065) are informational and include the State equivalent of a federal K-1. Nonresidents must pay State personal income tax, up to 8.82 percent, on their distributive shares ("pass-through") of State business income, while residents must pay the same on their shares of total income. Corporations integrate their pass-through of total income into their computations under the State corporate franchise tax, though federal S corporations (which generally don't pay federal income tax) are only subject to franchise tax if they so elect. The corporate tax rate is 6.5 percent.

As often happens, the City is a little different from the State. It imposes a 4 percent tax on partnerships, LLCs and sole proprietors that are, for the most part, engaged in active businesses in the form of an "Unincorporated Business Tax" (UBT). It also imposes a personal income tax, up to 3.876 percent, solely on residents, that includes their pass-through of total income; nonresidents do not have to pay City personal income tax.[3] Corporations integrate their pass-through of total income into their computations under the separate City taxes that apply to federal C corporations (which pay federal income tax) and S corporations. The City corporate tax rate is generally 8.85 percent.

Differences aside, the State and City generally characterize partnership and LLC income similarly for tax purposes, and the State personal income tax and City UBT impose similar, though not identical, methods for determining the portion of that income that is subject to tax. Because many asset managers operate through partnerships and LLCs, they are the most important taxes at issue for deferred compensation.

Since the computation of most state and local income taxes, including State and City taxes, start from federal taxable income, the most urgent question in the analysis often becomes where the money is earned, not how much is earned. That is the case here.

New Statements from the State and City about Deferred Compensation

The State and City tax departments did not lose sight of Section 457A in the blitz of 2017's federal tax reform, and each published statements that concern deferred compensation.[4] In both cases, the tax departments have advised that *all* of it must be recognized as business income—eligible to be taxed as such, subject to statutory methods for attributing that income to the State and City. The process of attributing income to specific states and localities is often called "apportionment."

The problem is that deferred compensation payments do not fit cleanly into the standard State and City approaches to taxing business income. The complications are two-fold: one, a company or person that reports deferred compensation may have a very different connection to the State and City in 2017 than, say, 2006, and, two, the amount originally deferred may be very different from the amount finally reported. So, like everything in tax, there

are traps and opportunities. Here are some of the highlights from the State and City memos:

- **New York Residents.** The State advises that residents must pay State personal income tax on the entire amount of deferred compensation they include in federal adjusted gross income. City residents must also pay tax to the City on the same basis. Credits for taxes paid to other states are available at the State, but not City, level. Generally, state and local tax authorities may tax the full income earned by residents and allow credits for taxes paid to other states, so this treatment is not a surprise.
  - A 2015 U.S. Supreme Court decision provides authority to challenge the absence of a City credit and the definition of residency (for those unlucky souls who find that two states consider them residents).[5] In that case, the Court decided that a Maryland county tax violated the U.S. Constitution because it failed to provide a credit for out-of-state taxes paid, and would result in multiple taxation if replicated around the country. The analysis can be applied not just to the City personal income tax, which does have some critical differences with the Maryland tax, but also to the State and City definitions of "resident." Those definitions can lead to the same income being taxed by more than one state if replicated around the country. The consequences can be significant for individuals that report deferred compensation and worth the challenge.
- **Nonresidents.** The State advises that nonresidents are taxable on the amount of deferred compensation that they include in federal adjusted gross income and that they derived from New York sources as an employee or owner/partner/member/shareholder of a business—in the current year or a previous year.[6] While the State's memo does not mention it, the City's personal income tax does not apply to nonresidents, individuals who no longer live in the City or those who never lived in the City, all of whom do not have to pay the City personal income tax on payments or distributions of deferred compensation that they receive.[7]
  - *The State's position means that a person who moved out of New York, who stopped working in New York or who receives a share of income from a pass-through entity that no longer does business in New York conceivably must still pay New York personal income tax on his or her deferred compensation that is connected to work previously done in New York*. For this position, the State may rely on the U.S. Supreme Court's recent opinion in *South Dakota v. Wayfair, Inc*., which eliminated the physical presence requirement for sales tax.[8] Though the decision does not address state income taxes, revenue-hungry states may read it as allowing them to tax individuals and businesses that receive income from customers or economic activities in their states, regardless of their physical presence. However, the permissibility of taxing an individual or income from a business that no longer has a connection to the State arguably stretches the U.S. Constitution beyond its established limits.
  - The State further advises that:
    1. Employees (and former employees) must determine the portion of their deferred compensation earned in the State in proportion to the days they worked in the State in the year they performed the services for the compensation.
    2. Partnerships, LLCs and sole proprietorships that have nonresident partners, members or owners must determine the portion of deferred compensation earned in the State for those nonresidents by (a) using their books and records for the year they

performed the services to earn the compensation, or (b) if that information is not sufficient, applying the standard apportionment formula that combines the business's property, payroll and gross income, but using data from the year they performed the services. This means the State portion of deferred compensation is determined separately from all other income the business recognizes in 2017.

3. S corporations that have nonresident shareholders must determine the portion of deferred compensation earned in the State for those nonresidents using, it appears, the 2017 formula that applies for State corporate franchise tax purposes—a formula that bears very little resemblance to the formula that applied in 2007. Unlike the prior formula, which looked to where services were performed, the current formula attributes income to the customer's location (and completely ignores property and payroll data). The new approach is often called "market sourcing." *Market sourcing potentially gives these corporations and shareholders an opportunity to attribute their Section 457A deferred compensation to offshore sources, at least on the State level, by claiming that the customer was located offshore* (for more on the City, see below).

- **C Corporations.** The State advises that federal C corporations are taxable under the State corporate franchise tax on the amount of deferred compensation that they include in federal taxable income and that they apportion to New York using the 2017 formula. *Again, this formula is entirely different from its 2007 ancestor and produces very different results*. Now, the corporation may use market sourcing for State tax purposes, which may result in attributing some or all of the corporation's Section 457A deferred compensation to offshore sources.
- **City Businesses.** The City advises that businesses are taxable on the amount of deferred compensation that they include in federal ordinary business income or taxable income, as applicable, and that is apportionable to the City pursuant to the 2017 formula, with reference to the services originally performed to earn the compensation. The City also indicates that payments of deferred compensation to former employees should be considered in the payroll factor. Accordingly, the City would apportion deferred compensation together with all other 2017 income under the 2017 formula, but the services originally performed to earn the deferred compensation would be the basis for sourcing it within that formula. If a business doesn't have the information it needs to analyze the origin of the deferred income, the City suggests using the apportionment percentage from the year the business performed the services as a proxy.
  - Even though it still incorporates a minor amount of property and payroll data, the City's UBT formula for apportioning income of partnerships, LLCs, S corporations and sole proprietorships has also evolved significantly from 2007 and provides more leeway to attribute income outside the City, particularly for registered broker-dealers. The City's apportionment formula for C corporations now uses market sourcing, like the State's, and potentially allows C corporations to attribute some or all of their deferred compensation to sources outside the City.
  - *The City has discretion to adjust items of income—and, in the corporate taxes, to change the timing of income—but New York law does not provide the City with the same specific authority as the State to look*

back to earlier years to impose tax.[9] Businesses in the City should therefore consider contesting the City's approach. In particular, a business must actually be doing business in the City in the year the City seeks to tax it, and businesses that have severed their ties may consider asserting that the City has no power to tax them on their deferred compensation under New York law— or the U.S. Constitution. Corporations should be aware, however, that the City may attempt to use its discretion to change the timing of corporate income by, subject to the statute of limitations, forcing recognition in an earlier year.

– The compounded growth of the original deferrals also allows businesses to argue that the growth does not constitute a charge for services performed. These sums are closer to passive investment income in substance, and the City UBT, in particular, applies its own concepts to the classification of income, independent of federal classifications, to determine tax. This framework gives businesses latitude to decouple deferred compensation from its federal character and analyze it according to the investment activities that define it in 2017, which may have more favorable consequences.

As indicated above, the State and City approaches to taxing deferred compensation are ripe for challenge. In particular, most asset managers will have multiple years of deferred income and associated growth to address—and it will be nearly impossible for them to correlate the proportion of their State and City activities in any particular year to the dollars they ultimately received. The dollars from all their years of deferral have been mixed and mingled and compounded, and the final result is something entirely different from the original deferrals. Therefore, it is entirely appropriate for businesses to push back on the State and City positions, which use the original services to bootstrap the growth into tax.

Possibly acknowledging this issue, the State invites individuals and businesses to request special approaches, but permission may not always be necessary. For example, New York law supports the State's approach to referring back to earlier years[10], but nonresidents should consider challenging the approach on U.S. constitutional due process grounds, especially given that the growth may far exceed the original deferral.

At the City level, self-help is expressly built into the statute for pass-through businesses. The City allows them to use an "other reasonable method" to attribute payments for services within and without the City. Unlike requests for alternative approaches that may be granted in the tax department's discretion, a reasonable method requires no pre-approval or demonstration that it's superior to any other method. This option works perfectly for deferred compensation because the final figure is so different from the originally deferred amount and the services that generated the original amount are so different from the passive investments that generated the growth— making it appropriate for businesses to apply more reasonable approaches.

Conclusion

Asset managers have many choices to make in deciding how to report Section 457A deferred compensation. While the tax impact may initially seem significant, further review and nuanced analysis may lead to much better results.

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Endnotes

[1] Section 457A only relates to compensation paid for the performance of services. A right to receive profits as a result of equity ownership is exempt from Section 457A.

[2] https://www.mayerbrown.com/files/Publication/5716fca8-dcbb-4ae3-9965-9041ce03e3c2/Presentation/PublicationAttachment/54f54202-c379-4d0c-8f98-95352d749d15/11911.pdf.

[3] N.Y.C. Admin. Code § 11-1701.

[4] See, New York State Tax Treatment of Nonqualified Deferred Compensation, TSB-M-18(2)C, (3)I (N.Y.S. Dept. of Taxation and Finance April 6, 2018), at https://www.tax.ny.gov/pdf/memos/multitax/m18_2c_3i.pdf; and Recognition and Allocation of Deferred Income from a Nonqualified Deferred Compensation Plan, NYC Finance Memorandum 18-6 (June 29, 2018), at https://www1.nyc.gov/assets/finance/downloads/pdf/fm/2018/fm-18-6.pdf.

[5] *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. ___, 135 S. Ct. 1787 (2015).

[6] N.Y. Tax Law § 631(b)(1)(F)

[7] N.Y.C. Admin. Code § 11-1701.

[8] *South Dakota v. Wayfair, Inc.*, 585 U.S. ___, 18 S. Ct. 2080 (2018).

[9] N.Y.C. Admin. Code §§ 11-508(h), 11-602.8(d), 11-604(9), 11-652.8(d), 11-654(9), *compare with* N.Y. Tax Law § 631(b)(1)(F)

[10] Tax Law § 631(b)(1)(F)

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