

New Legislation Limits Deferral of Compensation from Offshore Entities

By Ken Werner

The recently enacted Tax Extenders and AMT Relief Act of 2008, part of the bill signed into law by President Bush on October 3, 2008, contains a number of revenue raising provisions to partially offset its cost. Among these is the addition of new Section 457A to the Internal Revenue Code, which eliminates the ability to defer compensation payable by certain offshore entities, among others, to the extent such compensation is not subject to a substantial right of forfeiture.

Many investment funds marketed to both offshore and U.S. tax-exempt investors are set up as offshore corporations for U.S. tax purposes in jurisdictions that don't themselves impose income tax. These funds generally avoid subjecting themselves to U.S. income taxation. U.S. managers of these funds have often elected to defer compensation payable to them by the funds, delaying their receipt of taxable income. This benefits the U.S. manager, without causing any detriment to the offshore fund, since it doesn't receive any U.S. tax benefit (or foreign tax benefit) from paying the compensation.

Under new Code Section 457A, any compensation that is deferred under a nonqualified deferred compensation plan of a "nonqualified entity" (foreign corporations not subject to U.S. income tax or a comprehensive foreign income tax, and partnerships whose members are such foreign corporations or U.S. tax-exempt entities), will generally be included in gross income when there is no substantial risk of forfeiture of the compensation.

Compensation is subject to a substantial risk of forfeiture only if (1) entitlement to the

compensation is conditioned on the performance of substantial future services and (2) the possibility of forfeiture is substantial.

The legislation contains a number of rules dealing with special circumstances, and provides for the IRS to issue regulations to carry out its purpose that are likely to be extensive.

The legislation applies to deferred amounts attributable to services performed after December 31, 2008. Deferred amounts attributable to services performed before that time must be included in income by the later of the last tax year beginning before 2018, or the tax year in which there is no substantial risk of forfeiture of the rights to the compensation. The IRS is to issue guidance allowing a limited period to elect to accelerate compensation previously deferred to the date such compensation will now have to be included in income. (This guidance is necessary to avoid potentially violating the non-acceleration rules of Code Section 409A, Congress' last effort to limit deferred compensation.)

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or the person listed below.

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“Any compensation that is deferred under a nonqualified deferred compensation plan of a “nonqualified entity” . . . will generally be included in gross income when there is no substantial risk of forfeiture.”

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