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Offshore Deferred Compensation

On May 21, 2008, the U.S. House of Representatives (the "House") passed legislation that would substantially limit the ability to defer U.S. federal income tax liability through certain offshore deferred compensation arrangements. The primary purpose of the legislation, currently called the "Renewable Energy and Job Creation Act of 2008" (H.R. 6049), is to extend for one year a series of temporary tax provisions that expired at the end of 2007 or that are set to expire at the end of 2008. However, the proposed legislation also includes a number of revenue raising provisions, including the offshore deferral provision.

The proposed legislation would add a new Section 457A to the Internal Revenue Code of 1986, as amended (the "Code"), which would generally eliminate the ability of U.S. cash basis taxpayers to defer nonqualified deferred compensation earned from a so-called "nonqualified entity" (defined to include certain partnerships and foreign corporations)[1]. Any compensation that is deferred under a "nonqualified deferred compensation plan" (generally defined by Section 409A(d) of the Code) of such a nonqualified entity would generally be includible in the recipient's gross income when the right to the compensation is not subject to a "substantial risk of forfeiture."

Compensation is subject to a "substantial risk of forfeiture" only if a person's rights to such compensation are conditioned upon the future performance of substantial services by such person. This definition is less expansive than the definition of the same term under the Section 409A regulations—a distinction that is specifically designed to reach performance or incentive fees related to offshore hedge fund side pockets, unless those fee arrangements satisfy certain conditions.[2] Side pocket performance fee

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[1] A partnership is a "nonqualified entity" unless substantially all of its income is allocated to persons other than (i) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax and (ii) organizations which are exempt from U.S. federal income tax. A foreign corporation is a "nonqualified entity" unless substantially all of its income is either (i) effectively connected with the conduct of a trade or business in the United States or (ii) subject to a comprehensive foreign income tax. The term "comprehensive foreign income tax" means with respect to a foreign person the income tax of a foreign country if (i) such person is eligible for the benefits of a comprehensive income tax treaty between such foreign country and the United States or (ii) such person demonstrates to the satisfaction of the Secretary of Treasury that such foreign country has a comprehensive income tax.

[2] To avoid application of Section 457A, the side pocket performance fee would have to be determined solely by reference to the amount of gain recognized on the disposition of an "investment asset". For this purpose, an investment asset is generally defined as any single asset (other than an investment fund or similar entity) (i) acquired directly by an investment fund, (ii) with respect to which such entity does not participate in the active management of such asset and (iii) substantially all of any gain on the disposition of which (other than the nonqualified deferred compensation) is allocated to investors of such entity.

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arrangements that are not structured in accordance with Section 457A's requirements would run the risk of becoming subject to an additional 20% tax and interest at the underpayment rate plus 1% when the deferred performance fee becomes determinable.

Although this legislation has passed the House, it remains unclear whether it will be enacted. The President's advisors have publicly stated that they would recommend that the President veto the bill in its current form. In addition, a block of 41 U.S. Senate Republicans have pledged, in a letter to the U.S. Senate Finance Committee Chairman, to oppose revenue raisers to pay for extenders. However, the use of offshore deferred compensation as a revenue raiser may meet less opposition. In addition, a bill containing a similar provision that aimed to eliminate the use of offshore deferred compensation passed the House last year but was stalled in the U.S. Senate.

If enacted, the legislation will apply to amounts deferred which are attributable to services performed after December 31, 2008. Amounts deferred that are attributable to services performed before January 1, 2009 will be includible in income on the later of (i) the last taxable year beginning before 2018 or (ii) the taxable year when the amount deferred is no longer subject to a substantial risk of forfeiture. The legislation would also permit taxpayers to make charitable donations of deferred amounts that they are required to include in income in their last taxable year before 2018 under the foregoing provision without regard to the 50% limit on charitable contribution deductions.

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