

## Offshore Deferred Compensation Reform Act of 2007

(Rep. Emanuel/Sen. Kerry)

**Background:** Taxpayers can defer paying taxes immediately on their compensation either through "qualified" or "non-qualified" deferral arrangements. Most taxpayers make "qualified" deferrals, which are contributions to qualified plans such as 401(k) arrangements or Individual Retirement Accounts (IRAs). At the same time, taxpayers may also make what are called "non-qualified" deferrals. These arrangements are generally used by senior executives or other high-income taxpayers who want to defer amounts in excess of the qualified plan or IRA limits. Non-qualified deferred compensation arrangements differ from qualified compensation arrangements in a number of ways, but most noticeably is that there are no limits on the amount that can be deferred. There are also important differences between non-qualified deferred compensation arrangements that are arranged onshore versus offshore. U.S. companies that grant non-qualified deferred compensation to their employees are unable to receive a tax deduction equal to the deferred compensation until the compensation is paid to the employee. By contrast, offshore employers can locate in no-tax jurisdictions, provide deferred compensation to their U.S. employees, and suffer no economic loss, since the timing of the deduction isn't relevant when the employer doesn't have any tax liability. Accordingly, there is a preference in the Code for U.S. taxpayers to defer compensation in certain offshore jurisdictions: it provides a significant tax benefit to themselves, without any tax disincentive/disadvantage to their offshore employer.

**Problem:** There is a fundamental issue of equity between middle-class Americans who can elect to defer *up to* \$15,500 of income into qualified plans and an additional \$4,000 into their IRA's and higher-income U.S. taxpayers who can defer unlimited amounts offshore. Most recently, the issue has been highlighted by news accounts of U.S. hedge fund managers being able to defer billions of dollars of compensation offshore.<sup>1</sup>

### What the Legislation Would Do:

- Creates a new Section 457A of the Internal Revenue Code that eliminates the ability of U.S. taxpayers to defer nonqualified deferred compensation in offshore tax havens. Offshore nonqualified deferred compensation paid by a foreign corporation will be taxable income when there is no substantial risk of forfeiture to the compensation.<sup>2</sup>
- A foreign corporation is defined as any foreign corporation unless "substantially all" of the income of the corporation meets the following exemptions:
  - Effectively Connected Income to the United States: Income is effectively connected with the conduct of a trade or business in the United States; or
  - Tax Treaty with the United States: Income is subject to an income tax imposed by a foreign country that has a comprehensive income tax treaty with the United States, the corporation is eligible for benefits of the treaty,

and a deduction is allowed for compensation under rules that are substantially similar to the way in which the United States provides deductions for compensation; in addition, the Secretary is given authority to determine whether a foreign corporation that operates in a country without a formal tax treaty with the United States can qualify for the exemption.

- Effective Date of Legislation: The legislation will apply to amounts deferred in taxable years beginning after December 31, 2007.

## FOOTNOTES

<sup>1</sup> Anderson, Jenny. "Managers Use Hedge Funds as Big I.R.A.'s," New York Times, April 17, 2007.

<sup>2</sup> A substantial risk of forfeiture exists where the receipt of compensation is conditioned upon the future performance of substantial services in order to receive that compensation.