

Newsalert

International Tax Services – U.S. Inbound

January 13, 2009

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This Newsalert does not provide a comprehensive or complete statement of the taxation law of the countries concerned. It is intended only to highlight general issues which may be of interest to our clients.

For issues relating to this news alert please contact your local international tax services advisor or the specialists listed at the end of this article.

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Solicitation

IRS Issues Initial Guidance on the Current Taxation of Nonqualified Deferred Compensation

IRS Issues Notice 2009-8, which May Impact Broad Spectrum of Non-U.S. Companies Providing Deferred Compensation

Background

Section 457A, which was added to the U.S. tax law late last year as part of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, subjects to current U.S. taxation the deferred compensation of employees of, and other service providers to, certain “nonqualified” foreign corporations or partnerships. On January 9, 2009, the Internal Revenue Service released Notice 2009-8 as initial guidance under the nonqualified deferred compensation rules in the new Section 457A. The PricewaterhouseCoopers Human Resource Services group has prepared a comprehensive description of Notice 2009-8, which can be viewed here.

<http://www.pwc.com/extweb/pwcpublications.nsf/docid/852C4B616446BAA1852573DF0076B391>

In 2007, the Congressional Research Service prepared a report for Congress, which included a statement that a single hedge fund had deferred more than \$1.7 billion in fees since 1990. It was this type of perceived abuse, related to the deferred compensation earned by managers of offshore hedge funds, that Section 457A was enacted to address. However, the initial guidance issued in Notice 2009-8 has a more expansive interpretation of Section 457A and may impact the officers and employees of more traditional multinational corporations.

Overview of Section 457A

Section 457A broadly prohibits the deferral of compensation payable under a “nonqualified deferred compensation plan” maintained by a “nonqualified entity.” Under Section 457A (as relevant to foreign corporations):

- Generally, a “nonqualified deferred compensation plan” is any deferred compensation plan that is not a qualified plan under Sections 401 *et seq.* and includes any plan that provides a right to compensation based on the appreciation in value of the securities of the foreign corporation.

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- The key to application of the statute is the definition of a “nonqualified entity.” It means, in relevant part, any foreign corporation unless substantially all of its income is subject to a “comprehensive foreign income tax” (the “subject-to-tax test”). The statute further provides that the term “comprehensive income tax” means, with respect to any foreign person (e.g., the foreign corporation), the income tax of a foreign country if such person is eligible for the benefits of a comprehensive income tax treaty between such foreign country and the United States (the “treaty rule”).

Guidance Provided by Notice 2009-8

The Notice sets forth interim guidance in the form of Questions and Answers. Taxpayers may rely on the Notice retroactive to the effective date of Section 457A, which is generally effective with respect to compensation for services performed after December 31, 2008.

The critical question for foreign corporations providing deferred compensation to officers and employees that are subject to U.S. taxation (including U.S. citizens and residents, and foreign persons performing services in the United States (unless exempt from U.S. tax under a treaty)) is Q-8: “How is it determined whether substantially all of the income of a foreign corporation is subject to a comprehensive foreign income tax?” Answer A-8 provides a general rule (A-8(a)) and then an exception to the general rule (A-8(b)).

The General Rule

Under the general rule, the subject-to-tax test is met and, thus, the carve-out from application of Section 457A applies, if the foreign corporation is eligible for the benefits of a comprehensive income tax treaty between its country of residence and the United States, provided that the foreign corporation is not taxed under any regime or arrangement that is materially more favourable than the corporate income tax otherwise generally imposed by such country. Therefore, if a foreign corporation has obtained a tax ruling from the tax authority of its country of residence, for example, and as a result of the ruling, is subject to tax at a lower rate in that country, the foreign corporation may fail the subject to tax test, and its officers and employees may be subject to the anti-deferral rules of Section 457A.

Observation

At first blush, we see no statutory underpinning for the underscored proviso above. The statute simply says that substantially all the income of the foreign

corporation must be subject to a comprehensive income tax. Under the treaty rule, being resident in a country with a comprehensive income tax treaty meets the comprehensive income tax standard. The fact that a taxpayer may be subject to a lower effective rate of tax -- either because it qualifies for an incentive regime or because it has negotiated a ruling with its country of residence reducing the tax burden - - should not be relevant to whether its income is subject to a comprehensive income tax.

The Exception for Excluded Income

The exception to the general rule addresses the standard that “substantially all” of the foreign corporation’s income must be subject to tax. In brief, the exception for “excluded income” provides that the subject-to-tax test is not met if (a) the corporation’s taxable income excludes, in whole or in part, foreign source income, and (b) the aggregate amount excluded exceeds 20 percent of the corporation’s gross income.

The Notice defines “excluded foreign income” as follows:

- First, income is treated as excluded from gross income if (i) it is not included, or (ii) it is excluded by means of:
 - an exemption
 - an exclusion
 - a deduction (such as, a dividends received deduction)
 - taxation at a rate of less than 50% of the generally applicable rate or
 - other means, (*which is a direct quote from the Notice*).
- Second, for purposes of determining whether an item is excluded from gross income, in the case of foreign source income, U.S. tax law concepts of gross income control.

The Notice provides two exceptions to the excluded income category. Income will not be treated as excluded if: (1) it subject to US taxation as effectively connected income or (2) it is a dividend paid by a foreign corporation this is not, itself, a nonqualified foreign corporation.

The above rules for what constitutes excluded income can easily sweep in many traditional foreign multinationals. First, by including an exemption, exclusion, or deduction, the rule covers most countries’ methods of avoiding double taxation of foreign income.

- For example, many countries avoid double taxation of foreign dividend income by means of a participation

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exemption. If the corporation derives more than 20% of its gross income from foreign dividends from nonqualified foreign corporations and the dividends are entitled to the participation exemption, its officers and employees may be subject to the anti-deferral rules of Section 457A.

Similarly, if a foreign country uses a territorial system for avoiding double taxation -- such as excluding business profits attributable to a permanent establishment in another country (again, very common in many countries) -- the anti-deferral rules may be triggered.

Observation

By not carving out double tax relief measures from the subject-to-tax test, the vague additional standard of "other means" at the end of the above list creates considerable uncertainty. For example, is a foreign tax credit system that achieves effectively the same result as an exemption system an "other means" of excluding gross income? Subject-to-tax tests found in U.S. tax law address whether the income is treated as the income of the recipient, whether or not actually taxed. These tests commonly treat income as subject to tax where tax relief, such as an exemption, deduction, or credit is provided to avoid double taxation of income. The only thing that would appear to give any support to this expansive application of the subject-to-tax test is the legislative history of an earlier version of the legislation. The Joint Committee on Taxation Report (JCX-75-08), in discussing the early version, states:

The Secretary may provide guidance concerning the case of a corporation resident in a country that has an income tax treaty with the United States but that does not generally tax the foreign-source income of its residents (a "territorial country"). This guidance may address the question whether, or in which circumstances, substantially all the income of such a corporation will be considered to be subject to a comprehensive income tax if the corporation derives income not only from its country of residence but also from one or more countries that may or

may not have tax treaties with the United States. For example, it is intended that if a corporation resident in a territorial country that has an income tax treaty with the United States derives a portion of its income from dividends paid by a subsidiary organized in another country that also has an income tax treaty with the United States, and the dividends are paid out of income that is subject to tax by that other treaty country, the Secretary may provide guidance under which the dividend income is considered subject to a comprehensive income tax in determining whether substantially all of the income or the recipient corporation is subject to a comprehensive income tax.

However, it is difficult to read this limited authority (if any) to provide what is, in effect, an anti-abuse exception to the treaty rule as broad authority to create a highly expansive subject-to-tax test that is not tied to whether income received from outside the tested company's country of residence is subject to a comprehensive income tax.

Finally, by using U.S. concepts of gross income, a foreign corporation can be subjected to the anti-deferral rule simply because a payment received which its country of residence views as non-income (such as, a return of capital distribution or stock redemption from a subsidiary) is treated as a dividend under U.S. tax law.

Summary

The impetus for Section 457A can be found in the Congressional Research Service report referred to above. The concern focused on deferred compensation earned by managers of hedge funds. The foreign multinational community was concerned that the remedy crafted by Congress might be broad enough to cover deferred compensation paid by traditional multinational corporations to their executives that are subject to U.S. taxation. The treaty rule was included with the expectation that this would avoid an over-inclusive standard. However, the expansive interpretation of the subject-to-tax test and the proviso to the general rule would seem to defeat the motivation behind the treaty rule.

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