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Surprising International Implications of New Deferred Compensation Law

As detailed in the November 2004 **taxAlert**, the American Jobs Creation Act of 2004 drastically changes the tax rules applicable to nonqualified deferred compensation. Absent satisfaction of stringent requirements in new section 409A, employees covered by unfunded arrangements will lose deferral benefits and will instead be taxed upon vesting and subjected to hefty penalties. Additional provisions penalize certain kinds of quasi-funding, *e.g.*, through offshore trusts.

The breadth of section 409A touches many cross-border situations that may not have been in the original sights. Taxpayers with foreign operations and transient employees should be alert to potential trouble spots.

U.S. Citizens and Residents ("U.S. Persons")

U.S. Persons are generally subject to the U.S. tax regime with respect to worldwide income, regardless of source, apart from limited exclusions under Code section 911. Vexing section 409A compliance issues may arise for **U.S. Persons working for foreign employers, whether in the United States or abroad.**

1. **Funded Foreign Plans**. U.S. Persons working for foreign employers (or U.S. subsidiaries of foreign companies) frequently participate in foreign retirement plans or other employee benefit arrangements funded through a trust. Such a plan is unlikely to be covered by the section 409A exemption for U.S.-qualified employer plans.

   However, funded foreign plans may already be subject to the U.S. tax rules for nonqualified funded plans (sections 402(b) and 83), which incorporate a tax-on-vesting regime similar to new section 409A. Such plans would be largely exempted from section 409A under recently issued IRS guidance (Notice 2005-1, Q&A-4(e)), although exemption of appreciation in a participant's vested interest is less clear.

   A further issue is whether funded foreign plans will be caught by section 409A's penalty-added taxation of vested assets set aside in an "offshore" trust. Pending technical correction legislation would raise the stakes by retroactively applying section 409A. The offshore funding rules can be avoided if "substantially all the services to which the deferred compensation relates" are performed in the same foreign jurisdiction in which the trust is "located." However, this escape route may not be available in many common factual situations.

   Tax treaties between the United States and several foreign countries (*e.g.*, the United Kingdom) may helpfully foreclose the applicability of section 409A to certain types of plans. Hopefully the IRS will clarify that section 409A, though later in time, does not override contrary treaty provisions.

   Possible section 409A tripping points for foreign funded plans include: elections at the time of retirement; distribution of benefits on "events"; in-service distributions; and distribution timing for key employees.

2. **Unfunded Plans.** Unfunded deferred compensation arrangements attributable to a U.S. Person's services will almost certainly be subject to section 409A for accruals and/or vesting after 2004, if not covered by generally applicable exemptions. Possible section 409A trip wires include: the tying of plan payments to elections under foreign qualified-type plans; employer discretion to adjust payment timing; acceleration provisions; or subsequent payment elections.

   Section 409A captures a wide range of unfunded plans and employer promises, and a flaw with respect to a minor benefit could pull down larger ones under an IRS aggregation rule. Corrective steps may be difficult to arrange if the plan primarily affects non-U.S. persons. Treaty protection is also less likely.

3. **Equity-Based Deferred Compensation**. Certain kinds of stock options and SARs are exempt from section 409A. However, these exemptions turn on technical requirements that need to be evaluated carefully if foreign equity is involved.

4. **Foreigners Who Become U.S. Persons.** A nonresident alien who becomes a U.S. Person must worry about the application of section 409A to vested accumulations (and/or ongoing vesting or funding) under pre-

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existing foreign deferred compensation arrangements – even if derived from services rendered outside the United States while a nonresident alien. While there are arguments to take at least funded arrangements out of the scope of section 409A, clarification by the IRS would be helpful. Fortunately, the section 409A effective date rules would grandfather pre-2005 vested accruals, if "material modification" of the arrangement is avoided. Treasury personnel have understandably indicated that this is "most sympathetic situation" for consideration of administrative relief.

Non-Resident Aliens

The problematic situations for non-resident aliens ("NRAs") involve **nonqualified deferred compensation attributable to services rendered in the United States**. An NRA is subject to U.S. taxation whenever such deferred compensation is "taken into account," even if he is not rendering U.S. services in the current year. Thus, the rules of section 409A must be reviewed and followed to avoid accelerated taxation of the NRA in the year deferred amounts become vested. The effective date provisions of section 409A should protect pre-2005 vested accruals. Treaty provisions with respect to dependent or independent personal services may considerably reduce the reach of U.S. taxation in the NRA context, *e.g.*, for certain limited duration U.S. work.

Employers of NRAs rendering U.S. services should review the information reporting and withholding requirements imposed on both U.S. and foreign employers under section 409A.

Watch for IRS Guidance

The only explicit statutory opportunity to resolve these issues is in the context of the offshore trust funding provisions, if either substantially all the benefited services are foreign or the situation is ultimately determined in regulations not to "improperly" defer tax. This may help at the fringes, but foreign employer usage of foreign trusts is not the biggest problem. Most important is to confirm that arrangements already subject to the tax-as-vest provisions of sections 83 or 402(b) are not covered by section 409A, and to permit centralized funding situations.

Many of the remaining problems could be eliminated by exempting compensation for foreign services from the reach of section 409A, as well as participation in foreign qualified-type plans. Policy considerations could readily be mobilized to justify regulatory exemptions of this sort.

IRS and Treasury personnel have indicated that some international issues related to section 409A will be addressed in the next tranche of guidance this summer.

Employer Tasks

Section 409A is already in effect, subject to a one-year grace period for corrective amendments. Pending further clarifying guidance, employers with foreign connections – whether foreign companies employing U.S. Persons or foreign or domestic companies employing NRAs working in the United States -- should be tentatively reviewing their compensation arrangements for trouble spots. This review should not be limited to persons employed after 2004, since post-2004 accruals for pre-2005 employees could be reached.

International deferred compensation issues are not a particularly well articulated area of U.S. taxation and treaties to begin with. The potential application of section 409A in this context provides ample fodder for future debates and abundant opportunities for IRS guidance.

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New Developments on Contingent Attorney Fees

Two events in the past several months have significantly changed the landscape for federal taxation of contingent attorney fees. First, the American Job Creations Act of 2004 (AJCA) added Code section 62(a)(19)[(20)]. This section provides an above-the-line deduction for any otherwise deductible attorney fees and court costs associated with claims of unlawful discrimination, certain claims against the Federal Government, and private causes of action under section 1862(b)(30)(A) of the Social Security Act.

Second, the Supreme Court's decision in *Commissioner v. Banks* and *Commissioner v. Benaitas* resolved a long-standing split in the Circuits by holding that contingent attorney fees are included in the taxpayer's income, even if paid directly to a taxpayer's attorney. Prior to that decision, the Fifth, Sixth, and Eleventh Circuits excluded such fees from a claimant's income; the Second, Third, Fourth, Seventh, Tenth, and Federal Circuits included them in the claimant's income; and the Ninth itself was split, depending on underlying state property law. While these recent events clarify much about the treatment of contingent attorney fees, questions still remain.

Why it Matters

At first glance it appears that it should not matter if the portion of an award paid for contingent attorney fees are included in a taxpayer's income, so long as a deduction is allowed for the payment of the fees. However, the inclusion/deduction approach often results in a significant tax cost. This is because attorney fees generally are deductible only by taxpayers who itemize, and then only as miscellaneous deductions. Miscellaneous deductions are allowed only to the extent

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they exceed 2 percent of adjusted gross income (AGI), and overall itemized deductions are reduced for individuals with AGI over a threshold amount (currently about $146,000). On top of this, miscellaneous deductions are not allowed at all in the calculation of the alternative minimum tax. The combination of these limitations can leave a successful claimant with a minimal after-tax recovery. In the well-publicized *Spina* case, the winning plaintiff actually ended up owing tax in excess of her recovery.

Discrimination Suits and Section 62(e)

The AJCA changes address the problem through an above-the-line deduction for otherwise deductible attorney fees incurred in claims for unlawful discrimination and other limited actions. Attorney fees are still included in gross income, even when paid directly to the taxpayer's attorney, but the taxpayer is allowed an offsetting deduction in calculating AGI. As a result, only the net recovery is included in taxable income. This treatment is available for judgments or settlements occurring after October 22, 2004. "Unlawful discrimination" is defined in section 62(e) as an act unlawful under a long list of federal statutes, as well as a claim under any provision of federal, state, local, or common law providing for the enforcement of civil rights or regulating any aspect of the employment relationship.

The relief provided under this provision is broader than the exclusion for contingent attorney fees provided by some of the Circuits prior to *Banks/Benaitas*, since it applies without regard to state property law provisions relied upon in some Circuits and it applies to both contingent and non-contingent attorney fee arrangements, and to fee awards paid directly to claimants as well as those paid directly to a claimant's attorney.

There remain several issues to consider, however. Apart from whether a particular action qualifies as "unlawful discrimination," these generally will involve timing and reporting. For example, a plaintiff who pays attorney fees out-of-pocket in a year other than the year recovery is received will not be allowed the above-the-line deduction. That is because the deduction is limited to the amount included in the taxpayer's gross income for the taxable year on account of the judgment or settlement.

As to reporting, taxpayers are to include the attorney fees in income, generally as "other income", and then deduct the fees on line 35 of their 1040, annotating the deduction as "UDC." However, if a plaintiff receives a lump-sum award (from which the attorney's fees must then be paid), the plaintiff may need to report the income based on the underlying claim, for example, as wages if the claim is for back pay. Since that could require payment of employment taxes on attorney fees, it will be advantageous to both claimants and defendants to separately state the attorney fee portion of an award. In addition, the provision does not provide relief for reporting under the "Middleman" regulations, which require a payor to report the amount includible in gross income of a payee before fees, commission, *etc.* are deducted, since, as noted above, attorney fees for which an above-the-line deduction is allowed are first included in gross income. Defendants are thus required to report attorney fees on a 1099 issued to the claimant even when paying the fees directly to the claimant's attorney.

Banks/Benaitas

In *Banks and Benaitas*, the Internal Revenue Service appealed two Circuit Court decisions supporting the taxpayers' failure to report amounts paid for contingent attorneys' fees as income. In reaching its decision in these cases, the Supreme Court declined to comment on several theories raised by respondents and their amici because it appeared those theories were presented for the first time before the Court. More significantly, the Court did not address attorney fees awarded for claims under the False Claims Act or under statutes authorizing fee awards to prevailing plaintiffs' attorneys (fee shifting statutes). In the former case, such fees are eligible prospectively for the AJCA above-the-line deduction. It appears they may also be excluded for pre-effective date cases. There remains an argument that fees awarded under fee shifting statutes may also be excluded. However, the Tax Court does not appear receptive to this argument, with Judge Laro recently holding in *Vincent v. Commissioner* that fees received pursuant to a fee shifting statute are nevertheless includible in a claimant's income.

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European Court Tax Decisions Could Impact U.S. Taxpayers' Foreign Tax Credits

U.S. taxpayers with operations in Europe would be well advised to keep an eye on recent developments involving the European Court of Justice (ECJ). The March 2001 decisions of the ECJ in *Hoescht* and *Metallgesellschaft* found certain aspects of the U.K. Advance Corporation Tax (ACT) to be violative of the freedom of establishment enshrined in the European Community Treaty. These decisions had a significant potential for impacting the foreign tax credit position of U.S. persons.

Following the *Hoescht* and *Metallgesellschaft* decisions, a number of U.S. companies (as well as other companies not based in the European Union

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(EU)) initiated litigation in the U.K. High Court of Justice, Chancery Division, seeking to make the case that the nondiscrimination article of the U.S.-U.K. Income Tax Convention would justify a decision similar to those of the ECJ with respect to ACT. U.S. participants in the litigation were motivated in part by a concern that, if they did not press their case, ACT they had paid to the United Kingdom might be considered a noncompulsory amount not qualifying for a U.S. foreign tax credit under section 1.901-2(e)(5) of the Treasury Regulations.

The initial decision, rendered in November 2003 in *NEC Semi-Conductors*, was adverse to the claimants, but for a somewhat surprising reason. The High Court held that ACT might indeed be discriminatory insofar as the tax treaty was concerned but that the nondiscrimination provisions of treaties, insofar as they applied to ACT, were not incorporated in the law of the United Kingdom and did not afford a private right of action against the U.K. fisc. This was news, and a clear contrast with prevailing law in the United States. The decision is on appeal, and will be heard this summer.

More recently, two separate Advocates General have come out with opinions to the ECJ on issues that could similarly affect foreign tax credits. (Such Advocate General opinions are adopted by the ECJ at least 80 percent of the time.) On March 17, in *Banco Popolare di Cremona*, the Advocate General took the view that the Italian regional tax on production, "IRAP," was invalid as an EU-prohibited second turnover tax substantially similar to a VAT. The creditability of IRAP has long been grist for discussions between the United States and Italy, and interim rules on this issue were announced in IRS News Release IR-INT-98-6, March 31, 1998, pending renegotiation of the U.S.-Italy Income Tax Convention (currently stalled). If the Advocate General's position becomes final, whether by adoption by the ECJ or otherwise, IRAP cannot stand. If an ECJ decision was to be applied retroactively and Italy was required to issue refunds, U.S. taxpayers who failed to apply might be charged with having made noncompulsory payments and denied their U.S. foreign tax credits.

That same concern is even more relevant — or at least relevant to a broader audience — with respect to of the opinion of another Advocate General in *Marks & Spencer PLC*, rendered on April 7. Here the question was whether losses of a foreign subsidiary had to be counted in the tax base of a U.K. corporate group. To the surprise of some observers, the opinion found that inclusion was required unless the losses were accorded equivalent tax treatment (*i.e.*, allowed as losses for tax purposes) elsewhere. There are numerous questions about the implications of this "equivalent treatment" concept (computation of losses, effect of carryovers, application to permanent establishments, *etc.*), and it is too early to consider the matter closed. If anything remotely similar to *Marks & Spencer* becomes ECJ law, however, the effect could be considerable for groups in the United Kingdom. Moreover, there are a number of other EU jurisdictions that do not allow losses of foreign affiliates in their domestic group computations, and some that do allow such losses have more stringent requirements than an eventual decision of the ECJ might contemplate.

Thus, *Marks & Spencer* cannot reasonably be limited to the United Kingdom and could affect groups in many countries. To the extent U.S. persons have invested in such groups, they would have an even more direct entitlement to relief than U.S. persons whose U.K. affiliates paid ACT (the *Hoescht* situation) , since ultimate U.S. ownership would not be relevant in a *Marks & Spencer* context. The groups would have the same standing in the ECJ as Marks & Spencer itself had, and there would be no need to make the case that an income tax convention contains requirements similar to those of the EC Treaty. To the extent relief was not sought by U.S.-owned groups through appropriate claims, there could again be issues relating to Treasury Regulations section 1.901-2(e)(5).

Stay tuned. The pace of the ECJ decisions in the tax field has been accelerating. As of today the Court must be seen as a major indirect player in the U.S. domestic context, and anyone having business in Europe must come to grips with its sometimes unpredictable decisions.

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