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Act Affects Offshore Deferred Compensation Rabbi Trusts

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The American Jobs Creation Act 2004 and Internal Revenue Service (IRS) Notice 2005-1 have a significant effect on forms of non-qualified deferred compensation planning which make use of offshore 'rabbi trusts' (so named in reference to a ruling regarding deferred compensation for a rabbi). In addition to the changes discussed in "Tax Law Changes under the American Jobs Creation Act 2004", the act requires immediate inclusion in income of any non-qualified deferred compensation, plus a 20% penalty, unless certain requirements are met. The act also encompasses deferred compensation arrangements with non-employees such as directors and trustees.

Deferred Compensation Rabbi Trusts

A deferred compensation plan is any arrangement, including a trust,between an employer and an employee to pay compensation at some time inthe future. Tax law in the United States distinguishes betweenqualified and non-qualified plans when taxing deferred compensation.Deferred compensation paid to a qualified plan receives favourable tax treatment, including a deduction for the employer for plan contributions, benefits that grow on a tax-deferred basis until actually paid, and distributions that are generally eligible for rollover to other tax-deferred retirement plans. Non-qualified plans do not provide these tax benefits, but do allow a business to provide benefits to highly paid employees without having to meet the restrictive non-discrimination requirements and contribution limits of a qualified plan. In addition, before the act, these non-qualified plans were not subject to much government supervision.

Trusts have proved very useful for structuring non-qualified deferred compensation plans. Compensation paid to an irrevocable rabbi trust is not taxable when earned and placed in trust. The employer retains administrative powers over the trust. Although the assets of the trust are subject to the claims of the employer's creditors, the executive is protected from non-payment due to a change of control in the employer's management or ownership.

The employer continues to be taxed on the trust's investment gains and income. When payments are made to the employee from the trust, he or she is subject to tax on the original compensation, together with any appreciation, and the employer is entitled to a corresponding deduction. Over time, rabbi trusts became so popular that in 1992 the IRS released a model trust instrument to aid taxpayers and minimize the number of IRS ruling requests.

Planning with Offshore Rabbi Trusts before the Act

A foreign corporation generally pays no US tax on capital gains. Before the act, in circumstances where the economic substance and business purpose supported it, a foreign corporation without a permanent establishment in the United States could contract with a US corporation for the services of a US-based executive and compensate the executive through an offshore rabbi trust. Doing so would enable the executive to defer US tax on capital gains.

Similarly, for certain foreign executives temporarily based in the United States, compensation paid to an offshore rabbi trust could defer taxes during the period that the employee was subject to US income tax. Later, when the compensation was paid from the trust, if the employee was then tax resident in a country which was party to a tax treaty with the United States, he or she might not be subject to US tax on the trust distribution.

However, in the absence of a specific treaty provision, the United States generally taxes a trust distribution of deferred compensation if the services were performed in the United States.

Reduced Effectiveness of Offshore Rabbi Trusts

It is no longer possible to use an offshore rabbi trust to defer taxation of compensation paid to a foreign executive temporarily based in the United States. Under the act, assets set aside in trust after December 31 2004 to pay deferred compensation under a non-qualified plan arrangement are treated as compensation income currently taxable to the employee if the assets or the trust are located outside the United States. Tax is to be paid even if the trust assets are subject to the general claims of the employer's creditors. Trust income will be treated as additional compensation income currently taxable to the employee, rather than as income which is taxable to the trust or to the employer.

The only exception is for contributions to a trust located in a foreign jurisdiction, in cases where substantially all of the services to which the non-qualified deferred compensation relates are performed in that foreign jurisdiction. This exception means that the offshore rabbi trust may still be a viable planning option for the US executive temporarily based in a foreign country, because the grantor trust rules, which ordinarily prevent non-US persons from being taxed as owners of trust property for tax purposes (for further details please see "Taxation of Offshore Trusts and Impact of New Lower Tax Rates"), do not apply to compensatory trusts where distributions are taxable as compensation for services rendered. However, the cost of compliance with the new non-qualified deferred compensation plan rules and tax treatment in the foreign country may outweigh the tax savings on capital gains.

Impact on Existing Offshore Rabbi Trusts

The new non-qualified plan rules apply to:

- amounts deferred in taxable years beginning after December 31 2004;
- amounts deferred in taxable years beginning before January 1 2005, if the plan under which the deferral was made is materially modified after October 3 2004; and

- earnings on those deferred amounts.

Absent modification, assets deferred in a rabbi trust before January 1 2005 are grandfathered and not subject to the new rules. As a result, no 2005 deferral payments should be made to a pre-2005 grandfathered rabbi trust unless (i) both the trust and its assets are located within the United States and (ii) the act's new documentary and operational compliance requirements for non-qualified plans have been complied with (for further details please see "Changes to Non-qualified Deferred Compensation Arrangements"). The deadline for amending a non-qualified deferred compensation plan is December 31 2005.

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