

1994

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Recommended Citation

Ordower, Henry, A Theorem for Compensation Deferral: Doubling Your Blessings by Taking Your Rabbi Abroad (1994). *Tax Lawyer*, Vol. 47, pp 301-347, 1994.

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A THEOREM FOR COMPENSATION DEFERRAL: DOUBLING YOUR BLESSINGS BY TAKING YOUR RABBI ABROAD*

*Henry Ordower***

I. INTRODUCTION

Among the 1993 tax legislation's¹ repercussions will be increased pressure on employers to provide nonqualified, deferred compensation plans to their highly compensated employees. By combining increased rates on ordinary income,² a decreased compensation ceiling for contributions to qualified pension and profit sharing plans,³ and a slight skewing of rates in favor of the corporation,⁴ OBRA '93 sets the stage for accelerating the use of alternative tax deferral techniques. Since limitations on the deductibility of passive activity losses⁵ prevent use of traditional investment based tax shelters for deferral of compensation income, highly compensated individuals increasingly must look to nonqualified plans to defer compensation. The pressure for deferral may come even from employers wishing to avoid the new compensation deductibility limitation with respect to their chief executive and other highly compensated officers.⁶ At the same time, the economic instability which has plagued even some of the historically most

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¹Omnibus Budget Reconciliation Act of 1993 (OBRA '93), Pub. L. No. 103-66, 107 Stat. 312.

²OBRA '93 increased individual rates by adding a 36% top marginal bracket to section 1 for individuals with taxable incomes in excess of \$115,000 (\$140,000 on joint returns), as well as a surtax of 10% on taxable incomes in excess of \$250,000 (\$125,000 for married individuals filing separate returns) in the form of a 39.6% bracket under section 1. In addition, indexing of the 36% and 39.6% brackets was delayed until 1995. Pub. L. No. 103-66, §§ 13201(a), 13202, 13201(b)(3)(A), 107 Stat. 312, 457-61 (1993).

³OBRA '93 decreased the compensation ceiling under section 401(a)(17) and other provisions for qualified plan contributions to \$150,000 from \$235,000, as indexed for inflation. Pub. L. No. 103-66, § 13212, 107 Stat. 312, 471-73 (1993).

⁴OBRA '93 increased the maximum corporate rate under section 11 to 35%, which is 1% less than the maximum individual bracket (4.6% less including the surtax). Pub. L. No. 103-66, § 13221, 107 Stat. 312, 477 (1993). Prior to the change, the maximum corporate rate was 3% higher than the maximum individual rate.

⁵I.R.C. § 469.

⁶OBRA '93 created section 162(m), limiting the deduction for employee compensation to \$1,000,000 per year per employee. Pub. L. No. 103-66, § 13211, 107 Stat. 312, 469-71 (1993). The limitation applies to corporations required to report, under section 12 of the Securities Exchange Act of 1934, salaries paid to their chief executive officers and other individuals in the corporations' group of four highest compensated officers. I.R.C. § 162(m).

solid United States corporations⁷ leads individuals to prefer funded and semi-funded plans⁸ to unfunded, unsecured promises to pay compensation in the future.⁹

An understanding of the interplay among costs, benefits, and risks of non-qualified deferred compensation is central to informed deferral choices by both employers and employees. Since deferral costs and benefits on both sides of the employment relationship are quite sensitive to variances that arise in individual cases, the most effective way to express them is mathematically. With formulae in place, it is possible to explore the application of deferral in the framework of one relatively simple constant. Here, the constant chosen for that purpose is the rabbi trust. It is used to illustrate general deferral principles in both domestic and foreign settings. Against the backdrop of this dual analysis, the reader should be able to marry the formulae applicable in a particular employer-employee situation to the general principles for foreign or domestic situations to arrive at a reasonable planning base.

Part II of this Article examines the economic underpinnings of deferring income and seeks to develop a simple theorem of deferral and present it algebraically. After establishing the fundamental premise that, in the absence of a risk of nonpayment, deferral of compensation is almost invariably, economically beneficial to the employee, the Article shifts its focus to the rabbi trust. Part III includes a general discussion of rabbi trusts and their increasing popularity as a deferral device. The Article describes opportunities for offshore employers to use rabbi trusts in deferring compensation for their United States citizen or resident employees and identifies the rabbi trust's particular allure for employees of offshore employers, whenever the employees are, but the employers are not, subject to United States income tax. Part IV of the Article cautions that careful evaluation of the overall tax impact of rabbi trust arrangements on em-

⁷For example, International Business Machines, Corp. (IBM) reduced its staff from its 1985 peak of 405,000 employees to approximately 250,000 as of July 26, 1993. In 1991, IBM eliminated some 20,000 positions and in 1992 an additional 40,000. IBM estimated that 50,000 employees accepted an early retirement buyout through June 30, 1993, and it expected to cut an additional 25,000 to 50,000 jobs in the near future. Catherine Arnst, *At IBM, More of the Same--Only Better?* Bus. Wk., July 26, 1993, at 78. During the past two and one-half years, the market price of IBM's common stock has declined by more than 90 points. On February 20, 1991, IBM closed at more than \$137 per share. WALL ST. J., Feb. 21, 1991, at C2. As of September, 1993, closing prices consistently remained under \$49 per share.

⁸The terms funded and unfunded, as used in this Article, do not necessarily coincide with their technical definitions under the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (1974)(codified part in 26 U.S.C. and part in sections of 29 U.S.C.). This Article views the employer's irrevocable transfer of money or property to a third party for the benefit of the employee as funded, even if the transfer is subject to a risk of forfeiture and nontransferable for purposes of section 83. Until the employee fails to meet the conditions of the transfer resulting in the forfeiture, the money or property remains free from claims of the employer's creditors. Semifunded plans include rabbi trusts under which the employer sets funds aside for the benefit of the employee, but the funds remain subject to the claims of the employer's creditors if the employer becomes insolvent. See *infra* note 40 and accompanying text.

⁹Revenue Ruling 60-31, 1960-1 C.B. 174, established that an unsecured promise to pay compensation in the future is not includable in the employee's income until paid.

employees subject to United States income taxation is essential whenever the employee qualifies for the foreign earned income exclusion or becomes subject to foreign taxes on earnings. Part IV also catalogs various limitations on the utility of deferred compensation arrangements and rabbi trust funding when the foreign employer is subject to United States income tax or has United States persons as some or all its owners.

II. A THEOREM OF DEFERRAL

A. *The Theorem*

THEOREM: If tax rates on ordinary compensation income are level or decreasing, taxpayers benefit economically from deferring compensation income.

ASSUMPTIONS:

1. Tax payable on nondeferring taxpayers' investment returns is greater than zero.
2. Same investment opportunities available to all taxpayers whether they defer or do not defer tax.
3. No risk of nonpayment of the deferred compensation.

Since 1986, interest levels and the expectation that federal income tax rates might increase have led to reasonable decisions against deferral.¹⁰ Traditional wisdom instructs, however, that deferral nearly always is the taxpayer's best choice. With OBRA '93, Congress restored rates of federal income tax to levels suggesting that further rate increases are not an immediate threat and thus favoring deferral under most reasonable assumptions. While the outcome of a deferral analysis depends upon its underlying assumptions, only by assuming either (1) an increase in the ordinary income tax rate from the beginning to the end of the deferral period or (2) less favorable investment opportunities for deferred than for nondeferred amounts can one ever render the decision to defer compensation inopportune.

Simple algebra demonstrates the validity of this observation. In the following expressions:

1. "C" is some amount of compensation which the employee may defer and invest such that the investment return will not become subject to income tax until the deferral period terminates. At deferral termination the accumulated amount (C plus return on the investment) will be subject to tax at ordinary income rates.

2. "T_o" is the rate of tax on ordinary income.

¹⁰The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat 2085, 2096 (1986), reduced the maximum income tax rate for noncorporate taxpayers to 28% from its previous level of 50%. While the section 1 maximum rate later climbed to 31% it remained well below the 50% and higher rates which characterized the 1950s, 1960s, and 1970s. At the same time, interest rates throughout the late 1980s and early 1990s have been extremely low compared with the 1970s rates.

3. " T_c " is the rate of tax which will apply to the investment return if the employee does not defer the compensation, *e.g.*, it may be the preferential rate of tax applying to long term capital gain. In any event, T_c is less than T_o but greater than zero, *i.e.*, $0 < T_c < T_o$.¹¹

4. Rate " r " is the return on all investments of both deferred and undeferred amounts.

5. Finally, " n " is the number of periods (years, months) of deferral.

If the taxpayer chooses to defer the compensation, at the end of the deferral, the taxpayer will receive a payment of ¹²:

Expression 1.

$$C(1+r)^n$$

The taxpayer will have to pay tax on this amount at the rate T_o such that after tax the taxpayer will have:

Expression 2.

$$C(1+r)^n - T_o C(1+r)^n$$

Simplifying:

Expression 3.

$$C(1+r)^n(1 - T_o)$$

The employee who chooses not to defer must pay tax on the compensation at the beginning and will have the net after tax amount available for investment¹³ such that:

Expression 4.

$$C - (C \times T_o), \text{ simplifying} \\ C(1 - T_o)$$

Assume that the nondeferring employee can invest the after tax compensation in the same manner as the deferring employee and will pay no further tax on the investment return until the termination of the deferring employee's deferral period.¹⁴ The nondeferring employee will accumulate:

¹¹Obviously, if T_c is greater than T_o , deferral avoids the higher rate and is preferable.

¹²The expression $(1+r)^n$ is the general compound interest expression for a constant interest rate " r " with compounding at the end of each period. As note 15, *infra*, illustrates, the general result will not differ even if periodic returns fluctuate. Accordingly, use of a standard compound interest expression simplifies the representations in the following discussion.

¹³If the employee chooses to pay the tax with money from other sources in order to retain the property constituting the compensation, *i.e.*, employer stock, it is nonetheless accurate to reduce the invested compensation by the tax payable for purposes of the analysis. The employee could have used the funds devoted to the payment of tax to make the investment in employer stock in any event.

¹⁴Examples include an appreciating capital asset or an annuity contract.

Expression 5.

$$C (1 - T_o) (1 + r)^n$$

Note that the accumulated amount here is equal to the amount the deferring employee had after paying income tax at the end of the deferral period.¹⁵ To simplify further expressions, let "Y" be that accumulated amount, that is:

Expression 6.

$$Y = C (1 + r)^n (1 - T_o) = C (1 - T_o) (1 + r)^n$$

While the deferring employee has finished paying her taxes on the accumulated amount, the nondeferring employee has not. The nondeferring employee must pay tax on the investment return which has accumulated on the tax-paid compensation. The tax is payable on that return at the favored rate T_c which is lower than the rate on ordinary income. Nevertheless, unless rate T_c is zero (or less than zero),¹⁶ the nondeferring employee must have less after tax accumula-

¹⁵Multiplication is commutative so that:

$$C (1 + r)^n (1 - T_o) = C (1 - T_o) (1 + r)^n$$

If the rate of return, but not the rate of tax on ordinary, compensation income fluctuates from period to period, the result of the analysis remains valid as long as the rates of return on deferred and nondeferred amounts are equal during each period. Thus, the net compounded amount (before tax on the investment return on the nondeferred compensation as in the example in the text), as demonstrated in the following, is the same whether C is reduced by the ordinary income tax before it is invested (*i.e.*, no deferral), or the gross amount C is invested before taxes are paid and the compensation plus accumulated return diminished by the ordinary income tax on the full accumulated amount. To illustrate, assume "a," "b," and "c" represent differing rates of return, the following expressions represent the effect of compounding at those varying rates of return:

1. $C (1 - T_o) + C (1 - T_o) a + [C (1 - T_o) + Ca (1 - T_o)] b + [(C (1 - T_o) + Ca (1 - T_o)) b] c + \dots =$
2. $(1 - T_o) [C + Ca + (C + Ca)b + ((C + Ca) b) c + \dots] =$
3. $(1 - T_o) (C + Ca + Cb + Cab + Cbc + Cabc + \dots) =$
4. $(1 - T_o) C (1 + a + b + ab + bc + abc + \dots)$

The first expression shows accumulation on already taxed compensation, that is, compounding investment of the after tax amount $C(1-T_o)$. The second expression simplifies the first expression and illustrates that imposing the tax after accumulation, that is full deferral and compounded investment of the gross amount C, produces precisely the same result as paying the tax and then compounding. Expressions three and four further simplify and generalize this approach.

Thus for variable rates of return "x," the gross compounded amount is the same whether the tax is paid on the compensation before accumulation or after accumulation. The values of "x" based on the foregoing expressions would be 1, a, b, ab, bc, abc, . . . , in the following:

$$(1 - T_o) \sum_{x=1}^k Cx = \sum_{x=1}^k ((1 - T_o) Cx) = (1 - T_o) C \sum_{x=1}^k x$$

The difference in result for deferral or nondeferral is that the gross amount in the case of nondeferral must be diminished further by the amount of the tax on the aggregate return on investment.

¹⁶A zero rate might arise if the employee invests in obligations the interest on which is excluded from gross income under section 103 or if the employee dies before selling the appreciating assets so that her estate enjoys a new adjusted tax basis equal to the fair market value of the property on the employee's date of death (or alternative valuation date) under section 1014. Even if the deferring employee dies, the compensation income remains taxable as income in respect of a decedent under section 691.

tion than the deferring employee. That is, the deferring employee has amount Y after taxes, while the nondeferring employee has amount $Y - Z$, so that Z is the tax payable at the favored rate T_c on the accumulated return on her after tax invested compensation ($C(1-T_o)$). The amount of tax the non-deferring employee must pay is:

Expression 7.

$$T_c (Y - C (1 - T_o)) = Z$$

The result does not change if the investment loses money. As the deferring employee's accumulated amount decreases, her tax liability decreases at the higher ordinary income rate. The nondeferring employee benefits from the loss in the value of the investment only at the lower, "favored" rate.¹⁷ The claim of right rule will not ameliorate the adverse effect of the rate limitation. Since the employee correctly included the compensation amount in income as compensation when received, the employee's loss is not a restoration of an amount received under an adverse claim but rather the diminution in value of an independent investment. The inclusion and loss are not an integrated transaction in a tax sense so the special transactional accounting rules, claim of right, and tax benefit rule, are inapplicable.

B. *The Corollary*

Increasing tax rates do not indicate invariably that deferral is no longer the best choice, but they do make analysis more complex. The following section presents a corollary to the deferral theorem and an algebraic model for application of the corollary.

COROLLARY: In periods of rising tax rates on compensation income, the likelihood that taxpayers benefit economically from deferral of compensation income varies directly with both the rate of return and the length of the deferral period and inversely with degree of rate increase.

ASSUMPTIONS:

1. The tax payable on nondeferring taxpayers' investment returns is greater than zero.
2. Same investment opportunities available to all taxpayers whether they defer or do not defer tax.
3. No risk of nonpayment of the deferred compensation.

¹⁷In fact, the nondeferring employee may not benefit from the loss at all or may only benefit over a long period of time, thus deferring the loss, under the capital loss deductibility limitations of the Code. See I.R.C. § 1211.

LIMITATION: If the preferred tax rate T_c , adjusted to determine its after tax value (using the tax rate before the rate increase T_o), is less than the change in the ordinary income tax rate, deferral is never advantageous.

Even increasing rates of tax on ordinary income do not necessarily render current payment of tax rather than deferral the better choice. While the greater the degree of tax rate increment becomes, the more likely it also becomes that an election not to defer is the better choice, the specific case nearly always requires careful evaluation. Unlike the theorem offered in the previous paragraphs which proves that deferral economically is always preferable when tax rates are stable or diminishing, countervailing factors easily can reverse an initial conclusion favoring a decision not to defer. Rate of investment return and length of deferral operate in tandem to undermine the decision for current inclusion. The higher the rate of investment return or the longer the deferral period, the more likely it becomes that the computations will prove deferral still to be the better choice.

As an example using the 1993 rate changes, an employee whose tax rate would increase from 31%¹⁸ to 39.6%¹⁹ on her ordinary income during the deferral period but who pays no more than 28% on long term capital gain might think it best, in the example discussed in the preceding paragraphs, to include the compensation currently and pay tax on the investment return at the 28% long term capital gain rate. At a compounding investment rate of 10%, however, it will require only seven years of deferral to make the election to defer the better choice. Under the same tax rate assumptions but a compounding rate of return of only 3%, twenty years of deferral are needed before deferral becomes better than current inclusion.

Under most reasonable assumptions about changes in tax rates, deferral eventually becomes the better choice. Assuming a constant, positive rate of return,²⁰ an algebraic expression for this observation is:

Expression 8.

$$T_c (1 - T_o) \left[1 - \frac{1}{(1 + r)^n} \right] > T'_o - T_o$$

¹⁸Many taxpayers combined the 31% bracket with phaseout of the personal exemptions under section 151(d)(3) and limitations on itemized deductions under section 68 to produce a higher effective maximum rate. OBRA '93 made permanent the limitation on itemized deductions and the phaseout of personal exemptions. Pub. L. No. 103-66, §§ 13204, 13205, 107 Stat. 312, 462 (1993).

¹⁹The 39.6% rate generally affects taxable incomes in excess of \$250,000. I.R.C. § 1.

²⁰If investment losses are deductible at the rate of tax on ordinary income, the tax benefit from the loss may exceed the tax payable on the compensation when included in income. This Article does not address that possibility, but assumes positive rates of return on investments. Investment losses are likely to be capital losses which the tax law currently disfavors by limiting deductibility under section 1211. Even if the losses might be ordinary and fully deductible, decision-makers evaluating deferral options will assume positive returns. The possibility of a remote tax benefit tied to an investment loss is unlikely to influence the decision when the assumption of a positive return provides a current tax benefit.

where T'_o is the ordinary income tax rate at the end of the deferral period and is greater than T_o , the ordinary income tax rate at the beginning of the deferral period.²¹ The crossover point at which deferral and nondeferral produce the same economic result occurs when:

²¹Since:

$$1 - \frac{1}{(1+r)^n} = 1 - v^n = r \frac{(1-v^n)}{r} = r a_{\overline{n}|r}$$

Where, v^n is the present value factor $(1+r)^{-n}$ and $a_{\overline{n}|r}$ is the present value at discount rate "r" of an annuity for n periods with a periodic payment of 1, so that $ra_{\overline{n}|r}$ is the present value of an annuity yielding a payment "r" for n periods at rate r. An alternative expression of the comparison is:

$$(1-T_o)(T_c r a_{\overline{n}|r}) > T'_o - T_o$$

Where, $T_c r a_{\overline{n}|r}$ is the present value of an annuity yielding a periodic payment of size $T_c r$ (at rate r), so that $(1-T_o)(T_c r a_{\overline{n}|r})$ is the after tax present value of that annuity of size $T_c r$ with tax at the ordinary income rate applicable before the rate increase. Accordingly, if the present value of that annuity is greater than the change in tax rates (T'_o less T_o), deferral is the better choice.

The derivation of the comparison assuming (1) an increase in the rate of tax on ordinary income and (2) a constant, positive rate of return on invested deferred and nondeferred amounts follows:

Assume $T'_o > T_o$

$$1. C(1+r)^n(1-T'_o)$$

that is, the amount remaining after tax at the increased rate following full deferral of compensation. The following expression shows the amount remaining after paying tax at the original rate on ordinary income (without deferral), followed by investment of the net proceeds and taxation of the investment return at the preferred rate. See *supra* notes 12 to 16 and accompanying text for these expressions:

$$2. C(1-T_o) + [C(1+r)^n(1-T_o) - C(1-T_o)](1-T_c)$$

Whenever *Expression 1* is greater than *Expression 2*, so *Expression 1* less *Expression 2* is greater than zero, deferral is the better choice. Thus:

$$3. C(1+r)^n(1-T'_o) - [C(1-T_o) + C(1-T_o)(1+r)^n(1-T_c) - C(1-T_o)(1-T_c)] > 0$$

$$4. \text{Simplifying, } C(1+r)^n(1-T'_o) - C(1-T_o) - C(1-T_o)(1+r)^n(1-T_c) + C(1-T_o) - C(1-T_o)T_c > 0$$

$$5. \text{Further, } C(1+r)^n(1-T'_o) - C(1-T_o)(1+r)^n(1-T_c) - C(1-T_o)T_c > 0$$

$$6. \text{Dividing by } C(1+r)^n, 1-T'_o - (1-T_o)(1-T_c) - (1-T_o)T_c > 0$$

$$7. \text{Multiplying, } 1-T'_o - 1 + T_o + T_c - T_oT_c - \frac{T_c(1-T_o)}{(1+r)^n} > 0$$

$$8. T_c(1-T_o) - \frac{T_c(1-T_o)}{(1+r)^n} > T'_o - T_o$$

$$9. T_c(1-T_o) \left[1 - \frac{1}{(1+r)^n} \right] > T'_o - T_o$$

Expression 9.

$$T_c (1 - T_o) \left[1 - \frac{1}{(1+r)^n} \right] = T'_o - T_o$$

As the rate of return “r,” the length of the deferral period “n” or both “r” and “n” increase, the value of the fraction $1/(1+r)^n$ decreases bringing the crossover point closer. So, as the Corollary above states, the likelihood that deferral of compensation income will be economically beneficial in periods of rising tax rates varies directly with both the rate of return and the length of the deferral period. As the differential in the rates of tax (T'_o less T_o) increases, deferral becomes less attractive, *i.e.*, varies inversely with the degree of tax rate increase.

For any known increase in the tax rate on ordinary, compensation income and any known preferential rate of tax on investment returns, selection of a rate of return on investment of the deferred amounts determines the length of deferral period necessary to render deferral advantageous. Conversely, selection of a deferral period determines the rate of return on investments of the deferred amounts necessary to render deferral advantageous. Moreover, the length of the necessary deferral period and rate of return favoring deferral vary inversely with one another. That is, if T_o , T'_o , and T_c are all known, a given rate of return “r” requires a deferral period “n” such that:

Expression 10.

$$n > - \frac{\ln \left[1 - \frac{T'_o - T_o}{T_c(1 - T_o)} \right]}{\ln(1 + r)}$$

Similarly, a given length of deferral period “n” demands a rate of return “r” such that:

*Expression 11.*²²

$$r > \frac{1}{\sqrt[n]{1 - \frac{T'_o - T_o}{T_c(1 - T_o)}}} - 1$$

²²These relationships derive from the general *Expression 8*:

$$1. \quad T_c(1 - T_o) \left[1 - \frac{1}{(1+r)^n} \right] > T'_o - T_o$$

Solving for n:

$$2. \quad 1 - \frac{1}{(1+r)^n} > \frac{T'_o - T_o}{T_c(1 - T_o)}$$

Multiply by -1, add 1:

For sufficiently large tax rate increases, deferral never will become the better choice. Crossover cannot occur if the increase in tax rates equals or exceeds the after tax, preferred tax rate:²³

Expression 12.

$$T'_o - T_o \geq T_c(1 - T_o)$$

In 1993, for example, if a nondeferring taxpayer would pay tax on her investment return at the preferred, 28% rate on long term capital gains, Congress would have had to increase the ordinary income tax rate to 50.32% to render all deferrals from the previous, maximum, 31% rate unwise.²⁴ However, if the nondeferring taxpayer invests her after tax compensation such that her investment return is free of income tax, even the smallest tax rate increase on ordinary income renders deferral inferior to current payment of tax. As the preferred rate " T_c " is zero, rather than the long term capital gain rate, any advance in the ordinary income tax rate satisfies the antideferral condition in the comparison

$$3. (1 + r)^{-n} < 1 - \frac{T'_o - T_o}{T_c(1 - T_o)}$$

Take ln both sides:

$$4. -n \ln(1 + r) < \ln \left[1 - \frac{T'_o - T_o}{T_c(1 - T_o)} \right]$$

Divide both sides by $-\ln(1 + r)$:

$$5. n > - \frac{\ln \left[1 - \frac{T'_o - T_o}{T_c(1 - T_o)} \right]}{\ln(1 + r)}$$

Beginning with step 3, take the negative nth root of both sides, reversing the comparison, and subtract 1 to solve for r:

$$r > \left[1 - \frac{T'_o - T_o}{T_c(1 - T_o)} \right]^{-\frac{1}{n}} - 1$$

This expression is equivalent to *Expression 11* in the text.

²³In the comparison:

$$T_c(1 - T_o) \left[1 - \frac{1}{(1 + r)^n} \right] > T'_o - T_o$$

the expression within brackets approaches, but never reaches, 1, as $(1+r)^n$ increases thereby rendering the fraction smaller, but never 0:

$$\lim_{n \rightarrow \infty} \frac{1}{(1 + r)^n} = 0$$

Thus, whenever:

$$T'_o - T_o \geq T_c(1 - T_o)$$

deferral will not become desirable.

²⁴ $T_c = 28\%$, $T_o = 31\%$, $T_c(1 - T_o) = 19.32\%$.

set forth above.

Since the deferral theorem demands increasing ordinary income tax rates to support a decision not to defer, the employee or her advisers must evaluate the likelihood that a tax rate increase will occur. Possibilities for rate increase may be either public or personal. On the public side, Congress may choose to increase rates again as it did in 1993. Further federal income tax increases seem unlikely for the present, as the 1993 increases passed by extremely narrow legislative margins.²⁵ Similarly, the state in which the employee resides may increase income tax rates. State income tax rates seem more likely to increase than federal tax rates, but customarily those state increases are small compared with federal increments. Thus even short deferral periods and low rates of return will compensate for the rate increase at state levels fairly quickly.²⁶

Increasing personal income may cause the employee to move into a higher marginal rate bracket.²⁷ Current marginal bracket levels suggest that for highly compensated employees who most often are the employees considering large deferrals, significant bracket movement is doubtful.²⁸ The new 10% surtax²⁹ may affect some of the highly compensated, but its small, relative, additional cost is offset by a fairly short deferral period.³⁰ In evaluating bracket movement as an employee's earnings increase, the employee also must consider the effect of the phaseout of personal exemptions³¹ and the limitation on itemized deductions.³² Within their limits, these two adjustments have the same effect as a rate increase.

In addition, for some employees and independent contractors, the termination of the deferral period may occur in a year when they do not reach the applicable social security wage or self-employment income ceilings while they may have reached the ceilings in the year of deferral. The additional tax cost under current law in such a case is significant, as much as 6.2% for employees and 12.4% for

²⁵Because the Senate vote on OBRA '93 was tied, the Vice President's vote in favor of the bill was necessary. The House of Representatives' vote of 218 to 216 was not materially more favorable. 139 CONG. REC. S101763 (daily ed. Aug. 6, 1993). Some commentators might argue, however, that the next increase would be easier to support in Congress as the public will be more acclimated to rate increases than they were in 1993.

²⁶See *supra* note 19 and accompanying text.

²⁷Section 1(f) requires annual indexing of the marginal rate brackets but OBRA '93 delayed indexing of the 36% and 39.6% brackets until 1995. See *supra* note 2. Congress intended indexing to prevent inflation from causing movement into higher marginal brackets. See House Conference Report to the Economic Recovery Tax Act of 1981, H.R. REP. 215, 97th Cong., 1st Sess. 200 (1981), reprinted in 1981 U.S.C.C.A.N. 290.

²⁸The 36% bracket applies to married taxpayers filing jointly at \$140,000 of taxable income and to unmarried taxpayers at \$115,000 of taxable income. I.R.C. § 1.

²⁹OBRA '93 added an additional 39.6% marginal bracket to section 1 for most taxpayers with taxable incomes exceeding \$250,000. Pub. L. No. 103-66, § 13202, 107 Stat. 312, 461 (1993).

³⁰Applying *Expression 9*: assuming a compounding rate of return of 3%, a preferential rate T_c of 28% applicable to nondeferred returns on investment, less than eight years (7.587 years) of deferral will eliminate the effect of the higher marginal surtax bracket, and less than two and one-half years (2.353 years) will suffice if the rate of return is 10%.

³¹I.R.C. § 151(d)(3).

³²I.R.C. § 68.

independent contractors.³³ Social security taxes rarely are a material factor in an employee's decision-making with respect to deferral but may be for independent contractors. Even if the termination of the income deferral period occurs in a year when an employee does not reach the applicable, wage base contribution ceiling, the additional compensation generally is not subject to social security taxes in the year of payment because it was taxed previously.

Current law requires the payment of social security taxes on compensation deferred under a nonqualified plan in the year the employee performs the services rather than the year of payment.³⁴ If the employee wishes to defer the social security taxes, she must accept risk of forfeiture restrictions on the deferred compensation.³⁵ The Service does not view unsecured promises to pay compensation in the future as being subject to a risk of forfeiture simply because the employer may become insolvent and unable to pay the compensation when it becomes due. Rather the Service applies the same standards in determining risk of forfeiture as it does in the contingent compensation context.³⁶ Thus, the employee wishing to defer social security as well as income taxes will have to agree to an appropriate, enforceable forfeiture condition. Independent contractors who defer compensation through future payment agreements with their service recipients, on the other hand, must consider the effect of the self-employment income ceiling, as they are not subject to social security taxes until they receive the deferred payments.³⁷

III. DEFERRING INCOME THROUGH RABBI TRUSTS—OFFSHORE APPLICATIONS

A. Overview of Rabbi Trusts

The preceding section of this Article established that deferral of compensation

³³Section 3101(a) imposes the 6.2% tax on employees and section 1401(a) imposes the 12.4% tax on self-employment income. In addition, employers pay 6.2% tax on employees' wages under section 3111(a). The inflation adjusted ceiling on wages subject to the tax appears at section 3121(x) for employees and section 1402(k) for self-employment income. OBRA '93 eliminated the ceiling for the 1.45% and 2.9% medicare tax under sections 3101(b) and 1401(b), respectively. Pub. L. No. 103-66, § 13207, 107 Stat. 312, 467-69 (1993). Moreover, the deduction under section 164(f) for one-half the 12.4% self-employment tax as a trade or business deduction, *i.e.*, an adjustment to gross income under section 62, diminishes the overall cost of the self-employment tax by the taxpayer's tax rate multiplied by one-half the self-employment tax. Assuming a taxpayer in the full surtax position, the 12.4% is reduced to 9.948% [$12.4 - (.396 \times (12.4/2))$]. The deduction also applies to the Medicare tax.

³⁴I.R.C. § 3121(v)(2)(A)(i).

³⁵I.R.C. § 3121(v)(2)(A)(ii).

³⁶Consistent with the legislative history of section 3121(v), Private Letter Ruling 9051003 (Sept. 18, 1990) applied the regulations under section 83 in determining whether a substantial risk of forfeiture was present in a deferred compensation plan. Section 83(c)(1) defines substantial risk of forfeiture in terms of rights conditioned on future performance by the employee rather than risks associated with the solvency of the employer. *See* Regs. § 1.83-3(c).

³⁷Section 3121(v) does not apply to self-employment income, and no comparable provision for self-employment income exists. Since the timing of liability for self-employment taxes depends upon the individual's method of accounting, a cash basis taxpayer would not include the deferred compensation in the self-employment tax base until paid.

generally benefits the taxpayer economically and developed an algebraic model for evaluating the desirability of deferral given varying assumptions concerning rates of tax, investment returns, and lengths of deferral periods. This section applies the principle favoring deferral in exploring an increasingly popular deferral vehicle known as the rabbi trust. Rabbi trusts are a transitional financial product lying on the continuum between unfunded, unsecured promises to pay compensation in the future³⁸ and fully funded, deferred compensation plans.³⁹ Service recipients, including employers, settle such trusts to pay compensation to service providers, including both employees and independent contractors. Consistently favorable income tax rulings have treated the service recipients as the owners of the trusts under the grantor trust rules.⁴⁰ As grantor trusts, the trusts' income is taxable to the service recipient settlor and not the service provider.⁴¹ The designated employee beneficiary of the trust need include in income only actual trust distributions.

Acknowledging the consistency of its favorable advance ruling position concerning rabbi trusts, the Service issued model trust provisions for rabbi trusts in order to create a safe harbor and expedite the advance ruling process.⁴² In fact, the Service expressed its intention not to rule with respect to trust arrangements which do not employ the model provisions.⁴³

Similarly, the Department of Labor has accepted the grantor trust characterization and ruled on several occasions that the deferred compensation plans supported by rabbi trusts are unfunded for purposes of ERISA.⁴⁴ The Department of Labor ruled specifically that the Service's model trust provisions de-

³⁸Rev. Rul. 60-31, 1960-1 C.B. 174.

³⁹These include qualified plans under ERISA and nontransferable risk of forfeiture plans under section 83.

⁴⁰I.R.C. §§ 671-679. Private Letter Ruling 8113107 (Dec. 31, 1980) gave the product its name and held that a trust established by a congregation for its rabbi was a grantor trust because the trust remained subject to claims of the congregation's creditors. Accordingly, the rabbi did not have to include the value of the trust in his income when it was created, nor was he taxable on the income the trust earned.

Compare Minor v. United States, 772 F.2d 1472 (9th Cir. 1985), which held that the employer is the grantor and owner of a trust it creates to provide funds for payment of deferred compensation. While the trust held annuity contracts payable to the physician-employee, the physician-employee was not a beneficiary of the trust and the trust's assets were not insulated from the claims of the employer's creditors.

⁴¹I.R.C. § 671. To simplify language in the following, this Article uses the terms employer and employee rather than service recipient and provider even though the service provider may be an independent contractor.

⁴²Rev. Proc. 92-64, 1992-2 C.B. 422.

⁴³*Id.*

⁴⁴The Department of Labor, Pension and Welfare Benefits Programs has issued several opinions concerning rabbi trusts. Dept. of Labor, Pension, Benefit & Welfare Op. 91-16A, PENS. & PROFIT SHARING 2D ¶ ER4-5.35(10) (RIA) (Apr. 5, 1991) (a rabbit trust alone will not prevent a plan from being unfunded); Dept. of Labor, Pension, Benefit & Welfare Op. 90-14A, PENS. & PROFIT SHARING 2D ¶ 90,400 (RIA) (May 8, 1990) (assuming a rabbi trust does not prevent a plan from being unfunded but not specifically addressing that issue); and Dept. of Labor, Pension, Benefit & Welfare Op. 89-22A, PENS. & PROFIT SHARING 2D ¶ 90,360 (RIA) (Sept. 21, 1989) (treating a rabbi trust as an unfunded plan).

scribe an unfunded plan under ERISA.⁴⁵ The key to favorable tax and labor treatment of rabbi trusts historically has been the continuing exposure of the trust's assets to the claims of the settlor's creditors.⁴⁶

B. Trusts Not Subject to Claims of the Employer's Creditors.

Recently, however, the Service ruled that a rabbi trust with a stated preference in its trust agreement for investment in stock of the employer, accompanied by negation of the independent trustee's obligation to diversify investments, constitutes a grantor trust.⁴⁷ In as much as the creditors already have direct access to the employer's assets upon which the value of the stock depends, availability to those creditors of the trust assets is illusory as long as the trust holds only employer stock. Although the Service did not explain its reasons for requiring a basis for grantor trust treatment in addition to the traditional basis that the trust's assets remain subject to the claims of the employer's creditors, the ruling implies that an additional basis was essential. The Service concluded that the trust was a grantor trust, not as it had done in prior rulings for reasons relating to the employer's creditors' access to the trust assets in the event of employer insolvency, but because the employer retained a nonfiduciary power to substitute property of equal value for its shares held in the trust.⁴⁸ The ruling does not mention exposure to claims of the employer's creditors as a basis for grantor trust treatment at all. Subsequently, the Service incorporated the requirement that the employer retain nonfiduciary power in its model rabbi trust provisions for those trusts which will invest in employer stock. Yet the Service still requires that the assets of such trusts remain subject to the claims of the employer's creditors.⁴⁹

If a trust's assets are not subject to the claims of the employer's creditors, certain retained powers suffice to render the trust a grantor trust for federal income tax purposes.⁵⁰ Although the ruling concerning the rabbi trust which invests in employer stock contains much additional language and discussion, the ruling concludes that the grantor or employer "will be treated as the owner of the

In the Department of Labor, Pension and Welfare Benefit Programs Opinion 92-13A, PENS. & PROFIT SHARING 2D ¶ 90,454 (RIA) (May 19, 1992), the Department of Labor ruled that so-called top hat and excess benefit plans providing deferred compensation to a select group of management or highly compensated employees do not fail to be unfunded for purposes of sections 4(b)(5), 201(2), 301(a)(3) and 401(a)(1) of ERISA solely because the employer establishes a rabbi trust to provide the benefits.

⁴⁵Dept. of Labor, Pension, Benefit & Welfare Op. 91-16A, PENS. & PROFIT SHARING 2D ¶ ER4-5.35(10) (RIA) (Apr. 5, 1991).

⁴⁶For example, in Private Letter Ruling 9230012 (Apr. 24, 1992), the Service ruled that a rabbi trust is a grantor trust under section 671 with respect to the settling employer because trust income can be used to discharge the legal obligations of the employer without the consent of an adverse party. See I.R.C. § 677; Regs. § 1.677(a)-1(d).

⁴⁷P.L.R. 9235006 (Dec. 4, 1992).

⁴⁸*Id.* See I.R.C. § 675(4)(C).

⁴⁹Rev. Proc. 92-64, 1992-2 C.B. 442.

⁵⁰Section 675 lists administrative powers that lead to grantor trust treatment.

Trust's assets for federal income tax purposes."⁵¹ Since the grantor owns all the trust's assets, the employee would seem to be precluded from owning any interest in the trust's property.⁵² The Service's historical position with respect to grantor trusts supports this analysis that, for tax purposes, a grantor trust has no existence separate from its grantor as long as it remains a grantor trust.⁵³

For example, the Service concluded in Revenue Ruling 85-13, that a sale of property from the trust to the grantor is not a sale for tax purposes because the trust and the grantor are the same person.⁵⁴ In this ruling, the trust became a grantor trust because the grantor indirectly borrowed its assets,⁵⁵ and not because the assets remained subject to the claims of the grantor's creditors (as the assets are in favorable rabbi trust rulings). Thus, the ruling does not distinguish among bases for grantor trust classification. The Service determined that the grantor and the trust were the same for tax purposes.

The Service has consistently treated grantors and their trusts as identical. In the case of an irrevocable trust, which was administered and held title to assets outside the United States, had as beneficiaries only non-United States persons, but was treated as a grantor trust (for reasons not specified in the ruling), the Service ruled that the transfer of assets by a United States person to the trust was not subject to the excise tax on transfers of appreciated assets to foreign trusts until the trust ceased to be a grantor trust.⁵⁶ Only when it was no longer a grantor trust, owned by a United States person, did the trust become a foreign trust.⁵⁷ While a grantor trust, it and the grantor were the same person, and the grantor was a United States person so the trust was a United States person as well.⁵⁸

Case law also treats grantors and their grantor trusts as identical for tax purposes. In *Ringwalt v. United States*,⁵⁹ the court refused to separate a grantor from a trust when the grantor held certain administrative powers causing the trust to be a grantor trust. As a result, the court integrated formation of a

⁵¹P.L.R. 9235006 (Dec. 4, 1992).

⁵²See *World Publishing Co. v. Commissioner*, 299 F.2d 614 (8th Cir. 1962)(holding that two persons may own coextensive, depreciable interests simultaneously in a single asset.) *World Publishing* has been criticized for misunderstanding differing economic interests in property. See Henry Ordower, *Revisiting Realization: Accretion Taxation, the Constitution, Macomber, and Mark to Market*, 13 VA. TAX. REV. 1, n. 179 (1993).

⁵³The Service appears to wish to adhere to this principle. Accordingly, in the case of trusts not subject to the claims of the employer's creditors, the Service concludes that conflicts between grantor trust and other tax rules prevent grantor trust treatment. See P.L.R. 9207010 (Nov. 12, 1991) and P.L.R. 9206009 (Nov. 11, 1991)(the Service ruled that certain trusts cannot be grantor trusts because of a conflict between the grantor trust and section 402 rules even though the trusts have features that should make them grantor trusts). See *infra* note 75 and accompanying text for a discussion of these secular trust rulings.

⁵⁴1985-1 C.B. 184.

⁵⁵I.R.C. § 675(3).

⁵⁶Rev. Rul. 87-61, 1987-2 C.B. 219. The Service ruled that the section 1491 excise tax was inapplicable.

⁵⁷I.R.C. § 7701(a)(31).

⁵⁸I.R.C. § 7701(a)(30).

⁵⁹549 F.2d 89 (8th Cir. 1977), *cert. denied*, 432 U.S. 906 (1977).

corporation in which the grantor held the majority of the stock with the sale of assets by and liquidation of the corporation in which the grantor trust held the majority of the stock. Rather than respecting the taxpayer's structure of the transactions, the court applied the liquidation-reincorporation doctrine⁶⁰ to find that the liquidating corporation engaged in a tax-deferred reorganization with the newly formed corporation owned by the trust's grantor.⁶¹ Similarly, the Tax Court held in *Estate of O'Connor v. Commissioner*⁶² that an individual's powers over a trust may cause the individual to be treated as owning the trust's underlying assets and the trust to be disregarded for tax purposes.⁶³

However, contrary authority regarding the separate identity of the trust for tax purposes exists. *Rothstein v. United States* permitted an installment sale of property by a grantor trust to its grantor and taxed the gain to the grantor under the grantor trust rules.⁶⁴ Likewise, *W & W Fertilizer Corp. v. United States* held a grantor trust with an individual grantor to be an impermissible shareholder of an electing small business corporation.⁶⁵

If, despite contrary authority, the Service adheres to its view that a grantor trust has no existence separate from its grantor, the employer has made no transfer.⁶⁶ Therefore, the employer has done nothing more than an act comparable to creating a reserve on its books, and the employee has no inclusion in income.⁶⁷ As the trustee is obliged to pay the trust's assets only to the employee, this conclusion defies logic. Nevertheless, under this analysis, the tax rules governing grantor trusts create the fiction of no transfer. Without a transfer, there can be no inclusion under section 83 even though the employee's interest is nonforfeitable because a transfer to a person other than the employer is an essential element of inclusion under that provision. Absence of a transfer to the employee or a third party also should prevent operation of the economic benefit doctrine to cause inclusion in the employee's income because the employer, as owner of the trust's assets, has given the employee only the employer's promise to pay compensation in the future.⁶⁸

If the trust exists separately for tax purposes, a transfer for the benefit of the employee does take place. The economic benefit doctrine and section 83 include the present value of the nonforfeitable, economic benefit in the employee's

⁶⁰See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 14.54 (1987)(discussing the liquidation-reincorporation doctrine).

⁶¹I.R.C. § 368(a)(1)(D).

⁶²69 T.C. 165 (1977).

⁶³I.R.C. § 678.

⁶⁴735 F.2d 704 (2d Cir. 1984). The Service announced that it would not follow this decision. Rev. Rul. 85-13, 1985-1 C.B. 184.

⁶⁵527 F.2d 621 (Ct. Cl. 1975), *cert. denied*, 425 U.S. 974 (1976). Prior to amendment by the Tax Reform Act of 1976, section 1371 did not permit trusts to be shareholders of S corporations.

⁶⁶Rev. Rul. 87-61, 1987-2 C.B. 219.

⁶⁷See Rev. Rul. 60-31, 1960-1 C.B. 174 (discussing the Service's general position on the non-includability of such deferred compensation arrangements).

⁶⁸*Id.* Arguably, the creation of the irrevocable trust is analogous to the grant of a security interest to the employee which Revenue Ruling 60-31, 1960-1 C.B. 174, suggests would result in inclusion in the employee's income under an economic benefit analysis.

income currently.⁶⁹ The Service confronted this issue in the so-called secular trust rulings.⁷⁰

Those rulings concern trusts intended to be employer grantor trusts. The trusts' assets were not subject to the claims of the employer's creditors, and the employees' interests were not subject to a risk of forfeiture. In the facts of one ruling, the employer retained the right to the trust's income; in the other, the employer retained the right to designate the recipients of the income.

In both rulings the Service applied section 83, rather than the economic benefit doctrine, to include the value of the employee's interest in the trust, but not in its underlying assets, in the employee's income. The Service viewed the trusts as governed by section 402(b) which precludes the employer from claiming a deduction greater than its contribution. Accordingly, the Service concluded that the employer cannot be the owner of the trust for tax purposes and resolved the conflict between sections 671 and 402 in favor of section 402. The Service held the trust to be separately taxable.

While the secular trust rulings⁷¹ are hardly persuasive as they fail to account fully for the explicit statutory language of the grantor trust provisions, the ruling on the rabbi trust investing in employer stock is not inconsistent with those rulings.⁷² There the Service noted that the trust remains subject to the claims of the employer's creditors thereby preventing inclusion under both the economic benefit doctrine and section 83 of the Code.⁷³

The Service explained that no transfer of property takes place, not because there is no transfer, as grantor trust treatment would suggest, but because under the section 83 regulations, an item is not property if it is subject to the claims of the transferor's creditors.⁷⁴ The ruling failed to specify whether these bases for exclusion are essential to its holding or merely additional grounds for exclusion from income. In as much as the creditors' interest in the trust has no economic substance, absence of that interest should not be determinative of the outcome as long as the trust invests only in employer stock. But the secular trust rulings indicate that remaining subject to claims of the employer's creditors nevertheless is an indispensable element of the ruling.⁷⁵

Thus, it remains uncertain whether reliance solely on a basis other than claims of employer creditors would prevent current inclusion in the employee's income of sums transferred irrevocably for her benefit to an employer grantor trust. If remaining subject to the claims of the employer's creditors is key to the proper functioning of the rabbi trust, failure to retain that characteristic results in inclusion to the employee of both the value of the trust and its income. Although the

⁶⁹Compare the escrow account in (4) of Revenue Ruling 60-31, 1960-1 C.B. 174. The ruling, however, does not consider the possibility of the escrow account as an employer grantor trust.

⁷⁰See P.L.R. 9207010 (Nov. 12, 1991); P.L.R. 9206009 (Nov. 11, 1991).

⁷¹*Id.*

⁷²P.L.R. 9235006 (Dec. 4, 1991).

⁷³*Id.*

⁷⁴*Id.* (citing Regs. § 1.83-3(e)).

⁷⁵P.L.R. 9207010 (Nov. 12, 1991); P.L.R. 9206009 (Nov. 11, 1991).

trust is a grantor trust and its income is taxable to the employer, the employee's interest in the trust's income would vest as the income is earned and create an immediate transfer by the employer of the economic benefit of the trust's earnings to the employee as well. That amount could constitute additional compensation income.⁷⁶

Since the stakes of current inclusion in the employee's income of the trust value and earnings are high, most employees will be reluctant to position themselves for a conflict with the Service by relying on a ground other than exposure of the trust's assets to claims of the employer's creditors. An employer in dire financial straits might motivate an employee keen on deferral to take that position, since the tax cost of loss of the deferral benefit would be much smaller than the risk of the loss of the compensation resulting from the employer's financial failure.

In determining that the rabbi trust investing in employer stock was unfunded for ERISA purposes, the Department of Labor similarly emphasized that the trust's assets remained subject to the claims of the employer's creditors.⁷⁷ Access to the employer stock offers creditors no additional value behind their claims. The employer's insolvency might destroy the value of the plan assets whether or not the assets (employer stock) are subject to the claims of the employer's creditors. Nevertheless the Department of Labor's continued reliance on exposure of the trust assets to the claims of the employer's creditors is unsurprising. Although minimal, nonfiduciary, retained powers suffice to assure grantor trust tax classification for rabbi trusts, the Department of Labor may view such powers as inadequate to distinguish the rabbi trust from similar funding vehicles for qualified, funded plans which principally or exclusively hold employer stock, such as employee stock ownership plans (ESOPs).

In contrast to the Service, moreover, the Department of Labor lacks the tradition of ruling that grantor trusts have no separate existence from their grantors.⁷⁸ Until the Department of Labor offers further guidance on this matter, employers subject to ERISA jurisdiction should continue to expose the assets of rabbi trusts they settle to the claims of the employers' creditors. Despite the possible absence of the need for such exposure to guarantee grantor trust classification under the federal income tax laws, for the present, that exposure assures that the trust may avoid classification as a funded plan under ERISA.

C. The Employee's Viewpoint

From the designated beneficiary's perspective, the rabbi trust represents a pool of assets which the employer has segregated for the designee's benefit. Unless the employer suffers general financial failure, that pool of assets remains

⁷⁶Regs. § 1.83-3(e).

⁷⁷Dept. of Labor, Pension, Benefit & Welfare Op. 92-13A, PENS. & PROFIT SHARING 2D ¶ 90,454 (RIA) (May 19, 1992).

⁷⁸The Department of Labor has not issued any rulings on this subject. For rulings by the Service, see Revenue Ruling 85-13, 1985-1 C.B. 184, and Revenue Ruling 87-61, 1987-2 C.B. 219.

available to pay the deferred compensation when the compensation becomes due. Unlike the simple unfunded, unsecured promise to pay deferred compensation, the employer's nonliquidity will not prevent or delay the employee from collecting the deferred compensation. As opposed to the employer's creditors when the employer becomes insolvent, the employer may not use trust assets for general operational requirements. Amounts the employer allocates to an account on its books for the employee pursuant to an unfunded, deferred compensation arrangement are not segregated and are available for operations. The employer's access to trust assets depends upon the employer's insolvency—certainly an act of independent significance and hardly an expedient an employer would utilize just to provide itself access to the segregated funds.

Since there is no particular reason to choose a rabbi trust for payment of contingent compensation, the most common use for rabbi trusts probably is elective deferral of compensation, with or without an additional employer contribution.⁷⁹ Deferred compensation, which is contingent upon future activities of the employee, *e.g.*, performance of additional services or passage of a fixed period of time without the employee competing with her former employer, is suitable for funding through a trust free from the claims of the employer's creditors. Since the trust assets revert to the employer if the employee fails to meet the contingency, the risk of forfeiture prevents current inclusion in the employee's income.⁸⁰ Holding the assets subject to claims of the employer's creditors is unnecessary to provide the desired deferral of compensation.

The employee's right to payment from the rabbi trust customarily arises at a fixed time or fixed times in the future, but specific events such as a change in corporate control may trigger an immediate right to payment from the trust. Assuming that the employer is willing to create the rabbi trust and the employee does not require the use of the funds immediately, the issue for the employee becomes relatively straightforward. Does the economic benefit of the deferral of taxes outweigh the risk of employer insolvency? If, as discussed in the preceding section of this Article, the Service holds that tax classification as a grantor trust solely by virtue of the employer's retention of nonfiduciary administrative powers suffices as a basis for exclusion from the employee's income of the trust, and the Department of Labor ultimately concurs with the Service thereby treating the plan as unfunded for ERISA purposes, this risk issue for the employee disappears. As a result, the trust assets would not be subject to the claims of the employee's creditors, and the employee's access to the deferred compensation would become secure.

The employee also may secure payment of the amounts due from the employer through the trust by purchasing insurance against the employer's insol-

⁷⁹See Dept. of Labor, Pension, Benefit & Welfare Op. 90-14A, PENS. & PROFIT SHARING 2D ¶ 90,400 (RIA) (May 8, 1990) (the Department of Labor approved the use of elective deferrals in connection with a top hat plan employing a rabbi trust as its benefit payment vehicle).

⁸⁰I.R.C. § 83. The risk of forfeiture also postpones inclusion in the wage base for social security tax purposes. I.R.C. § 3121(v)(2)(A)(ii).

venency risk. The Service recently approved use of such insurance by beneficiaries of an employer grantor trust.⁸¹ Insuring against the employer's insolvency is only a partial solution to the employee's concerns because it is likely to be available only with respect to employers that are good credit risks. For other employers, the insurance will be either unobtainable or prohibitively expensive. While the employer may fund the insurance indirectly through additional cash compensation to the employee, the insurance cost alters the economics of the deferred compensation arrangement by increasing its cost to the employer and reducing the benefit to the employee. Cost to the employer is the insurance premium cost, and the employee will include the additional compensation in income without an offsetting deduction for the premium paid.⁸²

D. The Employer's Decision

For the employer, the rabbi trust issue is more complicated. Unless the employee's compensation is unreasonable⁸³ or the employee is subject to the new compensation deductibility ceiling,⁸⁴ deferral of the compensation means postponement of the employer's deduction and commensurately increased current tax liability. Moreover, the corporation must include the income earned by the trust in its income. As a result, the adverse tax effect of postponement of the compensation deduction compounds each deferral year to the extent of those earnings. At the same time, required segregation of the funds in the rabbi trust precludes the employer from using the deferred payment for general business purposes but does not defer the compensation liability for income statement and balance sheet purposes. Successful investment of the trust assets and its accompanying increase in compensation paid to the beneficiary employee may render the employee subject to the deductibility ceiling⁸⁵ or raise the specter of unreasonable compensation when the trust distributes. With respect to the latter concern, if payment of the amount the employer deposited into the trust would have been reasonable compensation if paid to the employee directly, the accu-

⁸¹P.L.R. 9344038 (Aug. 2, 1993). The Service conditioned its ruling on the employee rather than the employer negotiating the insurance arrangement.

⁸²*Id.* The Service ruled, without being asked, that payment of the insurance premium was a family, living, or personal expense nondeductible under section 262. The validity of this conclusion is questionable. Compare Private Letter Ruling 8321074 (Feb. 22, 1983), which ruled that a corporate executive may deduct premiums paid to insure against sudden termination of employment as ordinary and necessary business expenses analogous to job seeking expenses, with Revenue Ruling 81-193, 1981-2 C.B. 52, ruling that payments for disability insurance were nondeductible because they do not relate to business risks.

Whether or not deductible, many, if not most, executives will find that the deductibility limitations for employee business expenses preclude the tax benefit. I.R.C. §§ 162(a)(1), 63, 67. In addition to the 2% floor on miscellaneous itemized deductions, payment of the premium in advance for the full policy term results in a large inclusion in income but only amortization of the premiums by the employee over the term.

⁸³Section 162(a)(1) permits the deduction of only a "reasonable allowance for . . . compensation."

⁸⁴OBRA '93, Pub. L. No. 103-66, § 13211, 107 Stat. 312, 469-71 (1993), added new section 162(m).

⁸⁵I.R.C. § 162(m).

mulated, deferred amount should not constitute unreasonable compensation when the trust distributes.⁸⁶

Existence of the rabbi trust may bind high quality employees psychologically to the employer even though their deferrals are not subject to any risk of forfeiture. Although the trust funds are unavailable for operating purposes, they enhance the employer's balance sheet because they represent amounts available for payment of creditors.⁸⁷ In addition, the employer can ameliorate the ongoing impact of inclusion of trust income under the grantor trust rules by causing the trust to invest in tax exempt obligations,⁸⁸ appreciating but not dividend-paying, stocks and, in the case of a corporate employer, even dividend-paying⁸⁹ employer stock.⁹⁰ Investment in wholly tax exempt obligations undermines the employee's incentive to defer as the investment makes deferral and nondeferral economically equivalent, except when rates of tax on ordinary compensation

⁸⁶Regulations section 1.162-7(b)(2) addresses contingent compensation and fixes the time for testing reasonableness of compensation to the moment of contracting. Accordingly, the regulation concludes that if the contingency results in payment of an amount greater than the parties contemplated, the amount is nevertheless deductible. Strictly speaking, the regulation would not necessarily apply to arrangements involving contingencies unrelated to performance such as the success of the investment of noncontingent deferred compensation.

⁸⁷This would not apply to those cases in which the rabbi trust relies solely on retained administrative powers to provide grantor trust treatment, but the discussion in Part III.B of this Article concludes that such reliance may not satisfy the Service's criteria for a rabbi trust.

For the accounting treatment, see the discussion of the EMERGING ISSUES TASK FORCE, Financial Accounting Standards Board, Issue No. 84-15 (Fin. Accounting Standards Bd. Aug. 7, 1984). The employer generally consolidates the assets and earnings of the grantor trust. See, for example, the consolidated financial statements of American President Companies, Ltd. prepared by Arthur Andersen & Company. AMERICAN PRESIDENT COMPANIES, LTD., 1992 ANNUAL REPORT note 8 (1992) (*available in* LEXIS, NAARS Library, AR File). See also the consolidated financial statements of Avon Products, Inc. prepared by Coopers & Lybrand. AVON PRODUCTS, INC., 1992 ANNUAL REPORT note 9 (1992) (*available in* LEXIS, NAARS Library, AR File). So while the funding of the grantor trust does not decrease the compensation expense liability, the assets remain on the books.

If the trust were a grantor trust solely on account of retained administrative powers rather than its assets remaining subject to claims of the employer's creditors, the accounting treatment should differ. Transfers to the trust would defease the compensation liability, and the assets would not be consolidated in the same manner as transfers to trusts for qualified plans are not consolidated.

⁸⁸I.R.C. § 103. Under section 55, tax exempt obligations may increase individual and corporate taxable income under the alternative minimum tax. Under section 57(a)(5), otherwise excludable interest income on certain private activity bonds is an item of tax preference. In addition, all other interest excludable under section 103 is includable in the corporate, adjusted current earnings adjustment of section 56(c)(1). See also I.R.C. § 56(g)(4)(B).

⁸⁹The employer can defer taxation of appreciation by requiring the trust to retain shares acquired until distribution to the employee. At that moment, distribution of cash from sale or the shares in kind will result in a deduction under section 162 to offset the inclusion of gain from the shares. Gain would be includable even if the trust distributes the shares in kind because, under the grantor trust rules, the trust's distribution is the employer's distribution and results in a constructive sale of the shares. Compare Regs. § 1.83-6(b). No similar deferral is possible for dividends that are includable in the year of payment. Nevertheless, dividends may not be fully taxable as they generally qualify, at least in part, as corporate dividends received deduction under section 243.

⁹⁰Private Letter Ruling 9235006 (Dec. 4, 1991) ruled that under the grantor trust rules, the employer will not be taxable on the trust's gain from sale of employer shares or the trust's receipt of dividends from the employer with respect to employer shares.

income decline or the investment is unsuccessful.⁹¹ Investment in employer stock will not enhance the employer's balance sheet for the investment does not increase the pool of assets available to the employer's general creditors.⁹²

Certain employers remain neutral concerning the establishment of rabbi trusts for employees, as they are immune to the ill effects of the grantor trust rules, and the timing of the compensation deduction is irrelevant. For exempt organizations, like the congregation that received the first rabbi trust ruling,⁹³ the compensation deduction has no economic value. Inclusion of the trust income requires no payment of tax unless it is unrelated business income.⁹⁴ The exempt organization employer may avoid the potential unrelated business income issue by restricting trust investments to those which cannot generate unrelated business income.⁹⁵ Unreasonable compensation may pose a risk in that the government could argue that unreasonable compensation indicates the presence of private inurement in violation of the statutory requirement for exempt status.⁹⁶ As long as the compensation amount was reasonable when deposited in the trust, the government is unlikely to advance this private inurement argument because private inurement carries such grave consequences as loss of exempt status.⁹⁷ Similarly, employers in a loss position, and employers with substantial net operating loss carryovers,⁹⁸ are in no hurry to realize their compensation deductions. Overstatement of taxable income, relative to economic income, enables employers to consume the loss carryforward which otherwise might expire unused.⁹⁹

E. Foreign Employers and Rabbi Trusts¹⁰⁰

Other employers often neutral with respect to the economic impact on them of establishing a rabbi trust for employees include foreign individuals and entities, especially corporations. The timing of compensation deductions or inclusion of the trust income frequently will not be an issue to employers operating in low tax jurisdictions because the economic value of the deduction or cost of the

⁹¹See *supra* note 16 and accompanying text.

⁹²The assets contributed to the trust are used to purchase employer stock which then appears as treasury stock as a result of accounting consolidation. See, for example, the consolidated balance sheets of Energy Ventures, Inc., prepared by Arthur Andersen & Company. ENERGY VENTURES, INC., 1992 ANNUAL REPORT note 10 (available in LEXIS, NAARS Library, AR File).

⁹³P.L.R. 8113107 (Dec. 31, 1980).

⁹⁴I.R.C. § 512.

⁹⁵Section 512(b)(1), for example, excludes dividends, interest, and annuities from the base for determining unrelated business income.

⁹⁶Section 501(c)(3), for example, prohibits any private inurement.

⁹⁷According to recent news reports, the Service is exploring alternatives to revocation of exempt status in unreasonable compensation (private inurement) cases. See, e.g., Marlis L. Carson et al., *Inurement Tops Variety of EO Issues Discussed in New York*, 60 TAX NOTES 935, 936 (Aug. 16, 1993).

⁹⁸I.R.C. § 172.

⁹⁹Under section 172(b)(1), a taxpayer generally may carry back net operating losses for three years and carry forward net operating losses fifteen years.

¹⁰⁰The Service has ruled favorably on one foreign grantor, rabbi trust. P.L.R. 9330238 (May 18, 1993).

inclusion will not be significant.¹⁰¹ Other employers subject to substantial foreign tax rates may find that, in contrast to United States tax rules,¹⁰² local tax rules permit the mismatching of deduction and inclusion of compensation. In some jurisdictions, the employer may accrue and deduct the compensation expense when the employee performs the services even though the employer does not make payment until a later period. Even if local tax rules generally operate similarly to United States provisions which delay the deduction until the employee includes the amount in income,¹⁰³ local rules governing trusts nevertheless may differ from United States law. Deposit of the funds in an irrevocable trust for the employee's benefit may result in inclusion in the employee's income under foreign tax law or otherwise constitute sufficient payment to permit the foreign employer a current deduction in the foreign jurisdiction.¹⁰⁴

Moreover, United States characterization of the trust as a grantor trust is likely to be irrelevant under foreign law. Inclusion in the employer's income of the trust's income under United States law may not coincide with inclusion under foreign law. A foreign jurisdiction, which postpones the employer's compensation expense deduction pending the employee's inclusion, might not tax the employer on the trust's income. Under local tax rules, the employee or the trust itself may be taxable on the trust's income. In those countries which tax their residents and citizens only on income from sources within the country, establishment of the trust outside the foreign jurisdiction may free the employer, the employee, and the trust itself from taxation under the foreign law. If the employer establishes the trust in a low tax jurisdiction, trust income may not be taxed significantly.

In fact, if the employer settles the trust in the United States, the trust's income may not become subject to tax at all. As a grantor trust under United States law, its foreign grantor is the owner of the trust's assets for United States tax purposes. That foreign owner may not be taxable in the United States on the trust's income, whether from foreign or United States sources.¹⁰⁵

If a foreign employer settles a trust that must distribute its income to a United

¹⁰¹This Article addresses only United States tax consequences of compensation deferral. Accordingly, identification of specific jurisdictions to which the various suppositions concerning possible foreign tax treatment apply is beyond the scope of the Article. The Article offers a number of observations concerning foreign tax treatment in order to alert the reader to various planning opportunities which may be available in jurisdictions in which the reader is active. A survey of inconsistencies between United States and foreign tax treatment in this area would be a welcome addition to tax scholarship.

¹⁰²I.R.C. § 404(a)(5).

¹⁰³I.R.C. § 404(a)(5).

¹⁰⁴Inclusion in the employee's income under local law may prove problematic if the employee is subject to income tax in the foreign jurisdiction. Thus, the trust structure may be practical only for employees not subject to the foreign jurisdiction's income tax by virtue of treaty exemptions or performance of the services in another jurisdiction. The jurisdiction of performance may be a foreign jurisdiction or may be the United States itself.

¹⁰⁵Consider the converse application of Revenue Ruling 87-61, 1987-2 C.B. 219. See *infra* note 133 and accompanying text for discussion of grantor trusts, having foreign grantors, holding United States property and having United States trustees and beneficiaries.

States beneficiary, but United States tax rules classify the trust as a grantor trust, the trust's foreign grantor, not the United States beneficiary, is the recipient of the trust's income for United States tax purposes.¹⁰⁶ United States tax rules offer considerable flexibility for taxpayers who wish their trusts to be defective, such as grantor trusts, for federal income tax purposes. The trust assets need not be subject to the claims of the foreign grantors' creditors to be grantor trusts. So long as a foreign grantor retains, for example, a simple nonfiduciary power to substitute property of equal value for the assets it deposits into the trust,¹⁰⁷ the trust is a grantor trust with respect to its settlor.

Moreover, the foreign employer often need not concern itself with compliance with ERISA because its deferred compensation arrangements have insufficient connection with United States activities to become subject to ERISA.¹⁰⁸ Absent ERISA compliance duties, failure of the Department of Labor to rule that a rabbi trust is unfunded even if its assets are not subject to the claims of the employer's creditors¹⁰⁹ creates no barrier to reliance on the full flexibility of the federal income tax laws for grantor trust classification.¹¹⁰ Thus, the treatment of the trust as a grantor trust, for whatever reason, results in inclusion of the trust's income in the employer's, not the employee's income for United States tax purposes. However, it is less certain that the employee will not have a compensation inclusion initially under economic benefit principles and, additionally, will not have an inclusion whenever the trust earns income as an additional transfer to the trust, by the employer for the benefit of the employee, after the employer has included the trust's income in its own.¹¹¹ Without greater certitude on that issue, only employees of financially unstable foreign employers should consider relying on the employer's retention of administrative powers alone to render the trust a grantor trust.¹¹²

F. Advantages of Offshore Rabbi Trusts

As long as neither the employer is, nor its owners are, subject to United States tax jurisdiction, the trust may invest freely in a variety of offshore properties and entities without suffering the adverse United States tax consequences of the

¹⁰⁶Rev. Rul. 69-70, 1969-1 C.B. 182.

¹⁰⁷I.R.C. § 675(4)(C). Private Letter Ruling 9235006 (Dec. 4, 1991) confirms this conclusion with respect to administrative powers. Revenue Procedure 92-64, 1992-2 C.B. 422, includes this structure in its model provisions for rabbi trusts when the trust invests in employer stock. See, however, discussion of the "secular" trust rulings *supra* notes 69-76 and accompanying text.

¹⁰⁸29 U.S.C. § 1003 (1988).

¹⁰⁹See *supra* note 44 and accompanying text.

¹¹⁰I.R.C. §§ 671-679.

¹¹¹Inclusion of the value of her interest in the trust as compensation income should not cause the employee, rather than the employer, to be the grantor of the trust. On the other hand, if the inclusion resulted from the employee's power to withdraw the assets of the trust, she would be the grantor under section 678(a)(1), even if the power lapsed unexercised. I.R.C. § 678(a)(1). If the economic benefit principle resulted in the initial inclusion, it again would cause the employee to include the trust's income as additional compensation.

¹¹²See discussion *supra* Part III.B.

Code's antideferral rules applicable to entities which would constitute foreign personal holding companies,¹¹³ foreign trusts,¹¹⁴ controlled foreign corporations,¹¹⁵ foreign investment companies,¹¹⁶ and passive foreign investment companies¹¹⁷ if they had United States persons¹¹⁸ as owners. The employee's interest in the rabbi trust does not taint the trust's investment in the foreign entities. Until the trust ceases to be a grantor trust, the rabbi trust's sole owner is the foreign employer.¹¹⁹ The United States employee does not become an owner of the trust or its assets until the compensation deferral period ends.¹²⁰

For example, without adverse tax consequences to its United States beneficiary or employee, the rabbi trust may invest in a foreign investment company, a PFIC under United States tax law. The employee's holding period for purposes of the PFIC rules commences when the trust distributes the interest to the employee or, if earlier, when the trust ceases to be a grantor trust under United States law. Until the employee's holding period commences,¹²¹ the antideferral rules governing PFICs do not apply.¹²² The employee will not become subject to the interest charge on excess distributions attributable to periods before her holding period commences,¹²³ nor will she have any reason to make the qualified electing fund election before she becomes the direct PFIC shareholder.¹²⁴

Similarly, during the compensation deferral period, direct investment in securities or indirect investment through an intermediary such as a foreign trust or corporation remains free from all United States antideferral rules applicable

¹¹³I.R.C. § 552. Sections 551 through 558 govern foreign personal holding companies (FPHCs).

¹¹⁴Section 668 imposes an interest charge on accumulation distributions of foreign trusts, and section 679 treats foreign trusts as grantor trusts with respect to property contributed by United States persons as long as the trust has a United States person as a beneficiary.

¹¹⁵I.R.C. § 957. Sections 951 through 964 (except for section 963, which was repealed in 1975) govern controlled foreign corporations (CFCs).

¹¹⁶I.R.C. § 1246(b). Sections 1246 through 1248 govern foreign investment companies (FICs).

¹¹⁷I.R.C. § 1296. Sections 1291 through 1297 govern the United States tax consequences to United States persons who or which own stock in passive foreign investment companies (PFICs).

¹¹⁸Section 7701(a)(30) defines a United States person as a citizen or resident, a domestic partnership or corporation, or any estate or trust other than a foreign estate or trust. For partnerships and corporations purposes, domestic means that the entity was created or organized in the United States under the laws of the United States or any state. I.R.C. § 7701(a)(4).

¹¹⁹*Compare* Rev. Rul. 87-61, 1987-2 C.B. 219. United States owners are the jurisdictional key to application of each of the antideferral rules.

¹²⁰Section 671 treats the employer as the owner.

¹²¹I.R.C. § 1291(a)(3).

¹²²I.R.C. § 1291(a)(1)(A).

¹²³Section 1291(c) imposes an interest charge on deferred tax amounts. Deferred tax amounts are subject to the highest marginal rates for the shareholder applicable in the years to which amounts of excess distributions determined under section 1291(b) are allocated. I.R.C. § 1291(c)(2). This tax rate feature of the PFIC rules may be of little significance to some highly compensated employees, for the amount the employee receives from the rabbi trust is ordinary income—compensation for services. Section 1291(b)(2)(B) states that there is no excess distribution in the year the taxpayer's holding period commences, and section 1291(a)(1) allocates excess distributions only to days in the taxpayer's holding period.

¹²⁴Under section 1295, each owner of PFIC shares may make the qualified electing fund election with respect to her interest in the PFIC. Until the rabbi trust distributes, the employer, not the employee, owns the shares.

generally to offshore investments.¹²⁵ Even if the trust distributes the properties in kind, the properties have no historical, continuing taint under the various anti-deferral rules. The employee is deemed to have acquired the underlying interest in a fully taxable transaction on the date of distribution (or date the trust ceases to be a grantor trust).¹²⁶ The properties are not subject to any historical interest charge. If the antideferral rules apply at all to the investment in those properties, that application commences on date of distribution. The fair market value of the distributed properties is includable in the employee's income for United States tax purposes on the date of distribution.¹²⁷

Not only do offshore rabbi trusts prevent the United States employee from becoming subject to various antideferral rules, but they create the opportunity to capture tax advantages from investing in certain United States assets. A United States employer that owns a rabbi trust is subject to tax on the trust's income, including not only periodic payments on the investments in the form of dividends and interest, but also the trust's gains from sales or exchanges of capital assets.¹²⁸ In order to avoid tax on both periodic payments and capital gains, the United States rabbi trust must invest in employer stock.¹²⁹ However, without becoming subject to United States gross basis withholding taxes,¹³⁰ or taxes on net income,¹³¹ the rabbi trust settled by an offshore employer may collect interest from deposits in United States financial institutions and on evidences of indebtedness yielding portfolio interest.¹³²

Further, the offshore trust may invest in all nondividend paying United States growth stocks without becoming subject to United States tax on its gains from sales or exchanges of the shares.¹³³ In fact, most growth oriented United States properties, which make no periodic payments and are not direct or indirect interests in real property,¹³⁴ work equally well. Two rules prevent offshore grantor trusts and their foreign employer settlors from becoming subject to United States taxation on gain from the sale or exchange of United States personal

¹²⁵I.R.C. § 671.

¹²⁶*Compare* I.R.C. § 83. The employee receives a payment from the employer for tax purposes, even though the trust is the immediate payor.

¹²⁷*Id.*

¹²⁸I.R.C. § 671; Regs. § 1.671-3(a)(1).

¹²⁹*See* P.L.R. 9235006 (Sept. 8, 1992).

¹³⁰I.R.C. §§ 871, 881.

¹³¹I.R.C. §§ 1, 11.

¹³²Sections 871 and 881 impose a flat rate of tax which must be withheld at the source on the gross amount of certain generally periodic payments made to foreign persons. Treaty provisions often reduce the withholding rate of tax from the statutory 30%. Sections 871(i) and 881(d) eliminate the withholding tax on interest from deposits in United States financial institutions. Sections 871(h) and 881(c) eliminate the withholding tax on portfolio interest as defined in section 871(h)(2). Revenue Ruling 69-70, 1969-1 C.B. 182, expressly concludes that a foreign grantor of a grantor trust may be subject to section 871 on the trust's United States source income, even if the trust must distribute the income to a United States beneficiary.

¹³³I.R.C. §§ 871(a), 881(a). Section 865 sources gains from personal property sold by non-U.S. taxpayers outside the United States, so that the gains are not subject to United States tax.

¹³⁴Section 861(a)(5) sources United States real property gains to the United States, and section 897 treats the gains and losses from United States real property interests as effectively connected with a United States trade or business and subject to tax under sections 871(b)(1) and 882(a)(1).

property. First, as long as the properties are not effectively connected with the conduct of a trade or business in the United States, with some exceptions,¹³⁵ no gross base withholding tax on capital gains applies.¹³⁶ Further, income sourcing rules generally treat gains from the sale or exchange of personal property as United States gains for United States residents and non-United States gains for nonresidents.¹³⁷ Unless the trust is a United States person, it is a nonresident.¹³⁸ Consequently, its gain from sale or exchange of most personal property is sourced outside the United States. Since nonresident alien individuals and foreign corporations include in gross income only (1) gross income derived from sources within the United States and (2) foreign source income effectively connected with the conduct of a trade or business in the United States,¹³⁹ the gain is not includable.

As a result of the withholding and income sourcing rules, it appears that the trust itself need not be situated offshore in order to capture the tax advantages of an offshore rabbi trust. It is unnecessary, therefore, to seek compatible foreign law permitting the formation of a trust having the characteristics which cause it to be a grantor trust under United States tax law. Even if a United States person serves as trustee, and the trust holds its United States and foreign investments in the United States, the grantor trust rules treat the grantor as the recipient of the trust's income.¹⁴⁰ The trust itself is not subject to tax.¹⁴¹ In the case of a grantor trust, tax character of trust items depends on the grantor not the trust, as if the grantor received the item directly.¹⁴² Accordingly, the United States tax attributes of the grantor control the applicability of (i) the gross base withholding tax, (ii) rules governing the taxation of income which is effectively connected with the conduct of a trade or business in the United States and (iii) income sourcing rules. If a grantor who received the item of income directly would not have been subject to United States tax, the trust is not taxable either.

By extension, although administered in the United States, the trust nevertheless is a foreign trust while the employer is treated as the owner for tax purposes. United States tax law defines a trust as foreign if its "income . . . from sources without the United States which is not effectively connected with the conduct of a trade or business in the United States . . . is not includable in gross income under subtitle A."¹⁴³ Since grantor trusts include nothing in their gross income when the grantor is treated as the owner of the entire trust, either the grantor's tax characteristics define the trust or the trust is nonexistent for tax purposes.¹⁴⁴

¹³⁵Sections 871(a)(1)(D) and 881(a)(4), for example, impose a tax on gains from payments which are contingent upon the productivity of certain intangible assets.

¹³⁶I.R.C. §§ 871(a), 881(a).

¹³⁷I.R.C. § 865.

¹³⁸I.R.C. §§ 7701(a)(31), 865(g)(1)(B).

¹³⁹Section 872 applies to individuals and section 882(b) applies to corporations.

¹⁴⁰I.R.C. § 671.

¹⁴¹Regs. § 1.671-2(b).

¹⁴²Regs. § 1.671-2(c).

¹⁴³I.R.C. § 7701(a)(31).

¹⁴⁴Regs. § 1.671-3(a)(1).

The Service has ruled that for purposes of the excise tax on outbound transfers,¹⁴⁵ a grantor trust has no separate existence and remains a domestic trust as long as its United States grantor continues to be treated as the owner of the trust under the grantor trust rules.¹⁴⁶ The opposite conclusion should be equally true: a trust having a foreign grantor who is treated as the owner of the trust should be a foreign trust until the grantor trust rules cease to apply.

Despite the Service's position on the matter, some uncertainty exists as to whether the trust is or is not a separate entity for tax purposes. Nevertheless, if the Service continues to adhere to its position, it similarly should disregard the separate existence of a rabbi trust that a foreign employer settles in the United States. Since the foreign employer does not include foreign source income in its United States gross income, the trust itself should not.¹⁴⁷ Under the statutory definition,¹⁴⁸ as long as the employer or grantor is not a United States person, the trust is a foreign trust and its gains from sales of personal property are sourced outside the United States.¹⁴⁹ Accordingly, if the foreign jurisdiction in which the employer is located does not have comparable rules taxing grantors on the income of certain trusts, or the jurisdiction limits its taxation to its borders, the trust's income will not be taxable at all.

G. Candidates for Offshore Rabbi Trusts

Part IV of the Article demonstrates that the best candidates for offshore rabbi trusts are those employees for whom the foreign earned income exclusion and the foreign tax credit are of little significance. Employees with these characteristics include: (i) United States employees of foreign businesses who reside and perform their services in the United States; (ii) United States taxpayers who live abroad but fail to meet the residency test for the foreign earned income exclusion,¹⁵⁰ who are not subject to foreign taxes¹⁵¹ but who perform services outside the United States; and (iii) United States taxpayers who are highly compensated and consume their foreign earned income exclusions but reside in low tax jurisdictions so the foreign tax credit is of limited significance.¹⁵²

Appropriate employer characteristics often do not coincide with the employee characteristics that make offshore rabbi trusts particularly desirable. Many otherwise suitable employees have employers that are engaged in United States trades or businesses and subject to United States tax. Like United States nontax

¹⁴⁵I.R.C. § 1491.

¹⁴⁶Rev. Rul. 87-61, 1987-2 C.B. 219 (ruling that an outbound transfer of appreciated property to an offshore grantor trust drew no excise tax under section 1491 because the grantor continued to own the property; the trust was nonexistent for tax purposes).

¹⁴⁷I.R.C. § 7701(a)(31).

¹⁴⁸I.R.C. § 7701(a)(31).

¹⁴⁹I.R.C. § 865(a)(2).

¹⁵⁰Under section 911(d)(1), only bona fide residents of a foreign country or countries or individuals who satisfy the 330-day physical presence test qualify for the foreign earned income exclusion.

¹⁵¹Local tax rules or treaty exceptions may exempt certain types of temporary or short term employment from local taxation.

¹⁵²The section 901 credit cannot exceed foreign taxes paid.

exempt employers, such foreign employers are not neutral with respect to the effects on them of compensation deferral and use of the rabbi trust, as compensation deferral postpones their compensation deductions.¹⁵³ The employer is neutral with respect to compensation deferral through the rabbi trust if the employer (i) is not subject to United States taxation on its income, (ii) the United States employee's activities are unrelated to the foreign employer's conduct of a United States business;¹⁵⁴ and (iii) neither the timing of the compensation deduction nor the inclusion of the rabbi trust's income has a material impact on the employer.

Certain offshore investment entities having United States trading advisers combine both desirable employer and employee characteristics. Investment companies and commodities pools that employ United States advisers and brokers to trade on behalf of the entity in the United States markets do not become subject to United States taxes solely as a result of their trading and investment activities.¹⁵⁵ If solely non-United States persons who do not hold their interests in the entity in connection with the conduct of a United States trade or business own the investment company,¹⁵⁶ deferral of compensation for the United States investment advisers through rabbi trusts works nicely. Since the adviser does not become the owner of the trust's assets for United States tax purposes until the deferral period ends, investment of the rabbi trust's assets in foreign investment entities including the employer provides the adviser an opportunity to invest indirectly in such foreign entities without becoming subject to the antideferral rules generally applicable to such investments.¹⁵⁷

Similarly, foreign employers utilizing United States business or engineering consultants or temporary employees for work other than in connection with their United States activities may meet both employer and employee suitability criteria because they are not engaged in United States trades or business and not subject to United States tax while the consultants and employees are subject to United States taxation. In addition, employers operating in a foreign tax jurisdiction with low tax rates may cooperate in the deferral of compensation for their United States taxpayer employees who are not involved in the employer's United States operations, even if the foreign jurisdiction postpones the deduction until the employee has an inclusion.

IV. COUNTERINDICATIONS FOR OFFSHORE RABBI TRUSTS

As attractive as rabbi trusts appear in certain offshore applications, their utility is limited. From the employee's perspective, the foreign earned income

¹⁵³I.R.C. §§ 162, 404(a)(5).

¹⁵⁴Under sections 873 and 882(c)(1), nonresident aliens' and foreign corporations' deductions against United States income are limited to expenses connected with effectively connected income.

¹⁵⁵Section 864(b) excludes trading in securities and commodities through United States resident brokers from the definition of a trade or business in the United States.

¹⁵⁶I.R.C. § 864(b).

¹⁵⁷Without United States ownership, the entities are not subject to FPHC rules under sections 551 to 558, PFIC rules under sections 1291 to 1295, or CFC rules under sections 951 to 959.

exclusion and the foreign tax credit limitations may generate disincentives to rabbi trust usage. At the same time, conduct of a United States trade or business or United States ownership of any interest in the employer may compromise the rabbi trust's United States tax benefits severely.

A. Foreign Earned Income Exclusion and Foreign Tax Credit Considerations—Employee Concerns

Individuals who are subject to United States income tax on their worldwide income, including both citizens and resident aliens, may exclude \$70,000 of foreign earned income each year they reside and work abroad.¹⁵⁸ A taxpayer who qualifies for the foreign earned income exclusion should not consider deferring compensation unless her remuneration exceeds the exclusion ceiling. Compensation or pension and annuity payments the individual defers beyond the close of the taxable year following the year in which she performs the services do not qualify for the exclusion.¹⁵⁹ In analyzing the desirability of deferring compensation, moreover, the taxpayer must consider the potential tax rate impact of a deferral when she is in a foreign earned income exclusion position. Even a highly compensated individual may find herself in a lower marginal tax bracket than that bracket in which she would have been without the exclusion.¹⁶⁰ Thus, evaluation of the potential deferral demands attention to increasing rates.¹⁶¹ Movement between marginal brackets may render deferral improvident.

As noted, the foreign earned income exclusion permits deferral to the next taxable year without sacrificing exclusion qualification.¹⁶² That deferral is itself of little, if any, value, because it does not permit the taxpayer to double the foreign earned income exclusion. While the payments may lead or lag the employee's performance of services, the exclusion ceiling applies to compensation for the year of performance, not the year of payment.¹⁶³ Deferred and current compensation together consume the exclusion ceiling for the year in which the individual performs the services.

Taxpayers working in jurisdictions in which they pay a high rate of foreign tax generally should not defer foreign compensation for United States tax purposes unless they also receive deferral under the foreign jurisdiction's law. If the foreign jurisdiction does not tax United States persons living and working there on their worldwide income, they may avoid the foreign tax on the rabbi trust's income by locating the trust and its investments in the United States or a third jurisdiction which imposes a low tax or no tax on the investment earnings

¹⁵⁸I.R.C. § 911(b)(2).

¹⁵⁹I.R.C. § 911(b)(1)(B)(iv), (i), respectively.

¹⁶⁰For example, a single individual with taxable income of \$115,000 entitled to a \$70,000 foreign earned income exclusion would move from a 36% rate on additional income to a 28% rate on her next \$8,500 of income and 31% on the following \$61,500. I.R.C. § 1(c). These figures do not address the potential effect of the exclusion on the phaseout of personal exemptions or the limitation on itemized deductions under sections 151(d)(3) and 68 respectively.

¹⁶¹See discussion *supra* Part II.B (discussing the corollary to the theorem of deferral).

¹⁶²I.R.C. § 911(b)(1)(B)(iv).

¹⁶³I.R.C. § 911(b)(2)(B); Regs. § 1.911-3(e)(1).

of nonresidents.

Nevertheless, the mismatching of compensation deferrals likely will result in loss of foreign tax credits because of formula limitations.¹⁶⁴ While an inclusion under foreign law increases the amount of creditable foreign tax, deferral under United States law not only decreases the amount but also the fraction of United States tax against which to credit the foreign tax.¹⁶⁵ Despite the application of foreign tax rules to computation of the actual foreign tax payable, for foreign tax credit purposes, United States rules govern determination of the amount of foreign income deemed received by the taxpayer.¹⁶⁶ Postponing income for United States tax purposes excludes the income from gross income and from the taxpayer's income base for determining the foreign tax credit as well.¹⁶⁷ The taxpayer may carry the excess foreign tax paid back two and forward five years,¹⁶⁸ thereby mitigating and, except for the timing differential, in some cases eliminating, the adverse effect of the foreign tax credit limitation. For lengthy deferrals, the credit nonetheless would expire unused.

Following the deferral period, the amount of compensation for United States tax purposes should be greater than it would have been in the year deferred because a rabbi trust has invested the deferred amounts in the interim. If the deferral ends during the five-year carryforward period, the deferral and growth may enhance the usability of the excess foreign tax credits by increasing the amount of United States tax payable against which to credit the foreign tax and the fraction of the worldwide income attributable to the foreign source.¹⁶⁹

Conversion of United States to foreign source income may accompany the general growth in the amount of the foreign source income from compensation for both United States taxpayers having their tax homes within or without the United States. Both resident and nonresident United States taxpayers transform the rabbi trust's United States source income from interest and dividends into foreign source compensation income. The employer, as owner of the rabbi trust, includes the United States source income in income and pays it to the employee as compensation. Resident United States taxpayers also change the source of income from the sale of personal property, whether foreign or United States personal property, from United States source (if received directly) to foreign

¹⁶⁴Section 901 allows a credit for certain foreign taxes paid, subject to the section 904 limitation.

¹⁶⁵Section 904(a) limits the foreign tax credit to that proportion of the United States tax liability which the foreign source income bears to the taxpayer's income from all sources.

¹⁶⁶Regs § 1.904-6(a)(1)(iv), (c) Ex. (5). *See also* United States v. Goodyear Tire & Rubber Co., 493 U.S. 132 (1989)(holding that the deemed paid foreign tax credit computation under section 902 uses earnings and profits which the taxpayer determines applying United States tax rules and that at the same time, it is correct to compute the amount of foreign tax creditable under the rules of the applicable foreign jurisdiction).

¹⁶⁷The effect is to reduce both the numerator of the applicable fraction which is foreign source income and the denominator which is worldwide income by the same amount and consequently to diminish the fraction itself.

¹⁶⁸I.R.C. § 904(c).

¹⁶⁹By increasing the numerator and the denominator of the fraction for determining the maximum portion of the tax on worldwide income which the foreign tax credit may offset, the fraction increases.

source because the rabbi trust is a foreign trust.¹⁷⁰

At the same time as the United States taxpayer alters the source of some income, the taxpayer also shifts the income into a category different from the category for income received directly by the taxpayer.¹⁷¹ Compensation for services is included in the general limitation category income for purposes of the foreign tax credit.¹⁷² Most of the rabbi trust's investment income would belong in the passive or high withholding tax interest limitation categories if a United States person received the income directly from its source.¹⁷³ By capturing the rabbi trust's earnings as additional deferred compensation, the United States taxpayer has changed passive or high withholding tax interest income into general limitation income.¹⁷⁴

Under certain circumstances, shifts of income from one category to another for purposes of the foreign tax credit may benefit the taxpayer. When, for example, the foreign jurisdiction does not defer the compensation income but the United States does, the shift of categories may permit the taxpayer to consume more of her available foreign tax credit. If the foreign jurisdiction views the trust's investment earnings as the United States taxpayer's earnings, but imposes only a small or zero tax on investment earnings or capital gains, in contrast to the foreign jurisdiction's higher tax rate on compensation, the taxpayer will pay little foreign tax on the rabbi trust's income. A simultaneous increase in the general limitation category because the United States treats the trusts's earnings as compensation income enables the taxpayer to claim a foreign tax credit for more of the tax the foreign jurisdiction imposed earlier on the compensation she deferred.

This occurs because the taxpayer's compensation income (general limitation) includes the trust's income, but the trust's income did not draw any significant foreign tax. Thus, the tax payable on compensation in the foreign jurisdiction for which the taxpayer claims a credit has not increased significantly, but the amount of compensation (general limitation) income has increased by the amount of the trust's income for purposes of the general limitation foreign tax credit. The numerator and denominator of the foreign tax credit limitation fraction have both increased, thereby increasing the fraction, but the amount of foreign tax has not increased, thereby rendering more of it creditable.

To the extent the investment return on the deferred compensation draws a foreign tax, that foreign tax follows the income to the limitation category assigned by the United States tax principles. Although the United States would

¹⁷⁰I.R.C. § 865(a). Gains from disposition of personal property is United States sourced if a resident receives it, and foreign sourced if a nonresident is the recipient.

¹⁷¹Section 904(d) separates income into various categories or baskets and applies the foreign tax credit limitation separately to each category.

¹⁷²I.R.C. § 904(d)(1)(I). Such income is also referred to as the general basket.

¹⁷³I.R.C. § 904(d)(1)(A), (B).

¹⁷⁴Regs. § 1.904-6(a)(1)(iv), (c), Ex. (5). Note that when the effective foreign tax rate exceeds the highest United States rate of income tax, the passive category income subject to the tax becomes residual category income in any event. I.R.C. § 904(d)(2)(F).

have taxed the trust's income to the employer, even a gross base withholding tax on that trust income, which the foreign jurisdiction imposes on the employee's passive income,¹⁷⁵ becomes part of the taxes on general limitation income for foreign tax credit purposes.¹⁷⁶ A resulting increase in the aggregate foreign taxes attributable to general limitation income, however, makes the taxpayer less able to absorb her full foreign tax credit.

B. Foreign Employers Engaged in a United States Trade or Business

Once the foreign employer engages in a United States trade or business, the attractiveness of offshore rabbi trusts and deferral of employee compensation is likely to decline. Deductibility of employee compensation becomes a concern for the foreign employer, just as it is for a United States employer because it has economic value.¹⁷⁷ Unless the employee engages only in non-United States businesses of the employer, so that the employer's deduction for compensation relates to its foreign income only,¹⁷⁸ the deduction for United States tax purposes awaits the employee's inclusion.¹⁷⁹ But the stakes for the foreign employer may be higher than simple deferral of a deduction. If the employer ceases to conduct a United States trade or business between the commencement and termination of the deferral period, the employer may lose the compensation deduction for United States tax purposes because it has no effectively connected income against which to deduct the expense.¹⁸⁰ Moreover, returns on the rabbi trust's United States

¹⁷⁵Regulations section 1.901-2(f)(1) defines the taxpayer with respect to a foreign tax as the person upon whom the foreign law imposes liability for the tax.

¹⁷⁶*Id.*

¹⁷⁷See *supra* Part III.D.

¹⁷⁸Temporary regulations section 1.861-8T(c)(1) would apportion the deduction only to the residual grouping for which no deduction is allowable in the United States.

¹⁷⁹I.R.C. § 404(a)(5). If the employee's activities relate to both United States and foreign businesses, the regulation will apportion the deduction between effectively connected income and the residual grouping when the employee includes the compensation in her income.

¹⁸⁰A nonresident alien or foreign corporation may deduct expenses only if considered connected with effectively connected income. I.R.C. §§ 873, 882(c)(1). The taxpayer must allocate its deductions among her various classes of gross income, including gross income from business activities, and, whenever appropriate, further apportion the deductions within a class among the statutory groupings, including effectively connected income. Regs. §§ 1.861-8(a)-(f). A foreign employer allocates compensation expense to the business income class, and apportions the compensation between effectively connected income and the residual grouping.

Deferred expenses become subject to allocation and apportionment when they become deductible even if there is no income in the class to which they belong, as would happen following cessation of the conduct of any United States trade or business. Regs. § 1.861-8(d)(1). An excess of deductions allocable to effectively connected income over effectively connected income generates a net operating loss within that statutory grouping. While the taxpayer may carry the loss back, the carryback period is only three years. I.R.C. § 172(b)(1)(A). If the deferral period terminates more than four taxable years following the taxpayer's cessation of business in the United States, the net operating loss deduction will become worthless since it cannot be carried back to a year with effectively connected income. The longer, fifteen-year carryforward period also is of no value since the taxpayer will not generate effectively connected income in the future as it has ceased United States operations.

investments¹⁸¹ during the deferral period may be effectively connected income of the foreign employer and subject to United States taxation.¹⁸² If subject to United States taxation, the offshore rabbi trust may lose some of the advantages it has over the domestic rabbi trust.

Specifically, to the extent effectively connected with the foreign employer's United States trade or business, United States source fixed and determinable periodic income—including otherwise excludable portfolio interest and financial institution interest on deposits is earned by the rabbi trust—is includable in the employer's United States gross income.¹⁸³ United States source capital gain also is includable if effectively connected with the employer's United States trade or business.¹⁸⁴ Gain from the sale or exchange of personal property, other than inventory, generally has its source outside the United States if the owner of the property is not a United States resident or citizen.¹⁸⁵ The foreign employer which is the grantor of the rabbi trust generally meets this condition.¹⁸⁶ But if the nonresident maintains an office or other fixed place of business in the United States, and the sale is attributable to the office or other fixed place of business, the source of the gain is the United States.¹⁸⁷

United States source passive income and gain from the sale or exchange of capital assets are effectively connected with the United States trade or business if the income producing asset is used or held for use in the trade or business or the activities of the trade or business were a material factor in producing the income or gain.¹⁸⁸ Passive assets are held for use in the trade or business if they are "held to meet the present needs of that trade or business and not its anti-

Note, however, that effectively connected income is a single category even if the taxpayer has altered the United States business in which it is engaged. For example, *compare* regulations section 1.861-8(f)(1)(iv) with section 864(c)(1)(B) and regulations section 1.864-4(b). Accordingly, if the taxpayer commences a new United States trade or business within the net operating loss, carryforward period, the net operating loss from the compensation expense will become deductible against the income from that new business.

¹⁸¹With certain limited exceptions, passive income from sources outside the United States is not effectively connected with the conduct of a United States trade or business. I.R.C. § 864(c).

¹⁸²Under section 872(a)(2) gross income of a nonresident alien individual includes all effectively connected income. Similar rules apply to corporations under section 882.

¹⁸³Sections 871(a) and 881(a) exempt effectively connected periodic income from the gross base withholding tax. The exceptions for portfolio interest under section 871(h) and 881(c) and interest on deposits in financial institutions under sections 871(i) and 881(d) depend on general includability under sections 871 or 881. Accordingly, fixed and determinable periodic income, including portfolio interest and financial institution interest on deposits, is includable in the foreign taxpayer's United States income if it is effectively connected with the foreign taxpayer's United States trade or business. I.R.C. §§ 872, 882(b)(2). Nonresident aliens and foreign corporations are taxable on their effectively connected income. I.R.C. §§ 871(b), 882(a).

¹⁸⁴See I.R.C. § 864(c)(2); I.R.C. §§ 871(b), 872 (for individuals); I.R.C. § 882(a)-(b) (for corporations).

¹⁸⁵I.R.C. § 865.

¹⁸⁶I.R.C. § 865(a)(2). Section 865(g) defines nonresident for purposes of the personal property sourcing rule.

¹⁸⁷I.R.C. § 865(e). See I.R.C. § 864(c)(5) (to determine whether the sale is attributable to the office or other fixed place of business).

¹⁸⁸I.R.C. § 864(c)(2).

pated future needs.”¹⁸⁹ Since the assets of the rabbi trust are held for payment of compensation which is an operating expense of the trade or business, the assets probably satisfy this present needs test and, accordingly, the income and gain will be effectively connected with the United States trade or business and subject to United States taxation.

C. Effect of United States Ownership of the Foreign Employer

Even if United States persons own only a very small interest in the foreign employer, deferral of compensation and utilization of the rabbi trust to fund payment of the deferred compensation may affect those United States owners adversely. The grantor trust rules impute ownership of the assets and income of the rabbi trust to the foreign employer.¹⁹⁰ Therefore, the passive character of the trust's assets and income¹⁹¹ may cause the United States antideferral rules to penalize the United States owners. In addition, the interplay of computation of foreign taxes payable with the measurement of earnings and profits may reduce the owner's ability to consume available foreign tax credits.

1. Partnerships and Limited Liability Companies

The various antideferral regimes have little impact on entities treated as partnerships for United States tax purposes. United States persons who are partners in foreign partnerships or members of foreign limited liability companies, which have characteristics causing the United States to treat the companies as partnerships for tax purposes,¹⁹² include their distributive shares of the entity's income in their own incomes.¹⁹³ Since United States tax principles govern the United States inclusions and deductions flowing from the partnership,¹⁹⁴ deferred compensation is not deductible for United States tax purposes even if deductible in computing the partnership's and the partners' foreign tax liabilities.¹⁹⁵ Congru-

¹⁸⁹Regs. § 1.864-4(c)(2)(iii).

¹⁹⁰I.R.C. § 671.

¹⁹¹Section 954(c) defines FPHC income for purposes of determining foreign base company income under the controlled foreign corporation provisions. I.R.C. § 954(a)(1). Other definitions relate to this definition. See I.R.C. § 1296 (defining PFICs, especially subsection (b)). Under the FPHC, the definition of FPHC income is broader and includes certain active income from personal service contracts. I.R.C. § 553.

¹⁹²Revenue Ruling 88-8, 1988-1 C.B. 403, holds that regulations section 301.7701-2 determines the United States tax classification of foreign entities. Private Letter Ruling 9210039 (Dec. 11, 1991) applies the cited revenue ruling and regulations to classify a foreign limited liability company as a partnership for United States tax purposes.

¹⁹³I.R.C. § 702(a).

¹⁹⁴Section 702(b) provides that the character of items constituting the partner's distributive share have the same character as if the partner received them directly from the source from which the partnership received the item. United States tax classification determines the effect on the United States partner of the partnership level item. Rev. Rul. 67-158, 1967-1 C.B. 188 (applying the section 911 exclusion to a partner's distributive share of foreign source partnership income and limiting the earned income component to 30% when capital is a material income producing factor). See Regs. § 1.911-3(b)(2)(for the 30% limitation).

¹⁹⁵I.R.C. § 404(a)(5).

ity of United States and foreign characterization is unnecessary.¹⁹⁶ In fact, even the United States and foreign classifications of the entity for tax purposes need not be consistent.¹⁹⁷

In addition to including their distributive shares of the entity's income, undiminished by the deferred compensation expense, United States partners also include their distributive shares of rabbi trust's earnings in their individual incomes.¹⁹⁸ In contrast to dividend distributions from foreign corporations to their shareholders, which in effect may convert the corporation's United States source income into foreign source income for the shareholders,¹⁹⁹ passing the income through a partnership entity does not alter the source of the entity's income in its partners' hands.²⁰⁰ Thus, the United States partner becomes taxable on her share of the entity's United States source income, including that income of the rabbi trust which would be nontaxable to a foreign partner in the same partnership.²⁰¹

Despite the direct inclusion of the entity's income in the United States partner's own incomes, in certain respects, United States partners are situated more favorably than shareholders in foreign corporations, especially PFICs,²⁰² FPHCs²⁰³ and, to a somewhat lesser extent, CFCs which are not also PFICs or FPHCs.²⁰⁴ Foreign taxes paid by the partnership classified entity will be creditable even for noncorporate owners.²⁰⁵ Only 10% corporate, shareholders of foreign, corporate entities receive a foreign tax credit for the foreign taxes paid by foreign corporations in which they own shares.²⁰⁶ Noncorporate shareholders of PFICs and FPHCs receive only the equivalent of a deduction for the foreign taxes the corporation pays. Taxes payable reduce directly the undistributed FPHC in-

¹⁹⁶Rev. Rul. 88-8, 1988-1 C.B. 403.

¹⁹⁷*Id.* United States partners of the foreign partnership take their proportional shares of foreign taxes into account, even if the foreign taxing jurisdiction imposes the taxes on the entity. I.R.C. §§ 702(a)(6), 901(b)(5). Bruce N. Davis & Steven R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 TAX L. REV. 165, 277-79 (1991).

¹⁹⁸I.R.C. § 702(a). Section 671 treats the partnership as receiving each item of income the rabbi trust receives.

¹⁹⁹I.R.C. § 862(a)(2). If, however, 25% or more of the corporation's gross income is effectively connected with the conduct of a United States trade or business, its dividend distributions will be United States sourced. I.R.C. § 861(a)(2)(B).

²⁰⁰I.R.C. § 702(b). Note, however, that section 875(1) imputes the partnership's trade or business in the United States to each of its nonresident alien or foreign corporation partners.

²⁰¹Portfolio interest, interest on deposits, and certain dividends not effectively connected with the conduct of a trade or business in the United States remain free from the gross base withholding tax under section 871(h)(unless the foreign partner is a 10% shareholder of the issuer of the debt) and section 871(i).

²⁰²See discussion *infra* Part IV.C.2 (discussing PFICs).

²⁰³See discussion *infra* Part IV.C.3 (discussing FPHCs).

²⁰⁴See discussion *infra* Part IV.C.4 (discussing CFCs).

²⁰⁵I.R.C. §§ 702(a)(6), 901(b)(5).

²⁰⁶See discussion *infra* Part IV.C.5 (discussing the section 902 deemed paid foreign tax credit). Section 1293(f) applies the deemed paid foreign tax credit to PFICs. See also section 960 for application of the foreign tax credit to United States shareholders of CFCs.

come²⁰⁷ and the foreign corporation's earnings and profits.²⁰⁸ Concomitantly, reduction of earnings and profits diminishes the qualified electing fund (QEF), electing shareholder's ordinary earnings inclusion in the case of a PFIC.²⁰⁹ In the case of a CFC, foreign taxes relate less directly to noncorporate shareholders' inclusions. They reduce earnings and profits and the overall limitation on the shareholder's inclusion of CFC income,²¹⁰ but for many CFCs, the overall limitation is of no practical significance, as the corporation has more than adequate earnings and profits to cover the CFC inclusion in the United States shareholders' incomes.

Moreover, the subsequent deduction for the deferred compensation is less likely to go to waste for a partnership entity than for certain corporate entities. When it becomes deductible, the compensation expense reduces partnership income, and flow-through taxation of partnerships automatically reflects the deduction in the partner's distributive share of the income.²¹¹ If the deduction exceeds the income in the year of deduction, the partner, subject to adjusted basis²¹² and possibly passive activity loss deduction limitations,²¹³ may deduct her distributive share of the loss from her income from all sources.²¹⁴ If the loss exceeds her income from all sources, the partner may have a net operating loss²¹⁵ which she may carry back three taxable years and carry forward fifteen taxable years.²¹⁶ If the loss is suspended for lack of adequate adjusted basis in her partnership interest,²¹⁷ without any time limitations, subsequent increases in that adjusted basis resulting from future partnership profits,²¹⁸ capital contributions,²¹⁹ or borrowing at partnership level²²⁰ will render the suspended loss deductible. Similarly, if the loss is suspended under the passive activity loss limitations,²²¹ also without time limitations, future profitability in the partnership²²² or certain other activities,²²³ as well as disposition of the partnership interest in a fully taxable transaction,²²⁴ will permit the deduction of the suspended loss.

²⁰⁷I.R.C. § 556(a). Foreign taxes are deductible under section 164(a).

²⁰⁸I.R.C. § 164(a). *But see infra* note 247 (discussing foreign taxes, earnings, and profits).

²⁰⁹*See infra* notes 240-46 and accompanying text (discussing ordinary earnings and the QEF election).

²¹⁰I.R.C. § 952(c)(1).

²¹¹I.R.C. § 702(a).

²¹²I.R.C. § 704(d).

²¹³I.R.C. § 469.

²¹⁴Section 702(a) relates to both income and loss.

²¹⁵I.R.C. § 172.

²¹⁶I.R.C. § 172(b)(1).

²¹⁷I.R.C. § 704(d).

²¹⁸I.R.C. § 705(a)(1).

²¹⁹I.R.C. § 722.

²²⁰Section 752(a) treats an increase in a partner's share of partnership liabilities as a contribution to the partnership, so section 722 applies.

²²¹I.R.C. § 469(a).

²²²I.R.C. § 469(b).

²²³Since section 469(b) treats the suspended loss as incurred in the next taxable year, all income and losses from passive activities, including the suspended losses, aggregate as they do in the year in which each loss actually occurs.

²²⁴I.R.C. § 469(g).

2. *Passive Foreign Investment Companies*²²⁵

A foreign corporation becomes a PFIC if 75% or more of its income is passive or at least 50% of its assets produces passive income.²²⁶ Since the assets the rabbi trust holds are passive,²²⁷ and the corporation owns those assets and income for United States tax purposes,²²⁸ the rabbi trust increases the likelihood that the corporation will be a PFIC. The trust's income counts as part of the corporation's passive income and the value of its assets as passive assets in applying the PFIC tests.

If the corporate employer is a PFIC, each United States person who or which owns shares becomes subject to the PFIC antideferral provisions.²²⁹ These rules tax excess distributions²³⁰ attributable to taxable years in the shareholder's holding period preceding the year of distribution at the highest marginal rates which could be applicable to the shareholder.²³¹ The rules also impose an interest charge at statutory rates from the year to which the excess distribution is attributable.²³² Excess distributions bear no direct relationship to the profitability of the foreign corporation. They are a function of the amount of the distributions and not a function of the corporation's earnings and profits or other measure of profitability. Excess distributions include gain on the sale or exchange of the shares in the PFIC.²³³ This gain would have been capital²³⁴ but becomes taxed at the highest marginal rate which could be applicable to the shareholder.²³⁵

Shareholders may avoid the excess distribution provisions by electing QEF

²²⁵This Article does not deal with foreign investment companies (FICs) governed by sections 1246 and 1248 separately. All FICs will be PFICs, so the FIC antideferral rules now add little bite to the PFIC antideferral regime. *See generally* BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL U.S. TAXATION OF FOREIGN INCOME AND FOREIGN TAXPAYERS ¶ 68.4 (1991).

²²⁶I.R.C. § 1296(a).

²²⁷Section 1296(b)(1) applies section 954(c) to determine whether an asset or the income it produces is passive. Dividends and interest, for example; are passive income as is the gain from the sale or exchange of property producing such income. I.R.C. § 954(c)(1)(A), (B). Similarly, gain from dealings in commodities is also passive. I.R.C. § 954(c)(1)(C). The trust is likely to invest in one or more such properties. However, if the trust invests in employer stock, the stock will not be a passive asset since it neither produces nor can produce income to the employer. Gains are not taxable under section 1032, and the employer is not taxable on dividends it pays itself with respect to its shares. *See* P.L.R. 9235006 (Dec. 4, 1992).

²²⁸I.R.C. § 671.

²²⁹I.R.C. § 1291.

²³⁰Section 1291(b) defines total excess distributions generally as the excess of the amount of distributions in a taxable year over 125% of the average of the previous three years' distributions. Section 1291(a)(1) allocates the excess distribution ratably on a daily basis to each day in the taxpayer's holding period.

²³¹I.R.C. § 1291(c)(2).

²³²I.R.C. § 1291(c)(3). The statutory rate is the section 6621 rate of interest imposed on underpayments.

²³³I.R.C. § 1291(a)(2).

²³⁴Before enactment of the PFIC provisions, gain on sale or exchange of FIC shares was ordinary income to the extent of the shareholder's ratable share of the FIC's earnings and profits. I.R.C. § 1246(a)(1). Some PFICs would have been subject to FIC treatment. *See* I.R.C. § 1246(b)(definition of an FIC).

²³⁵I.R.C. § 1291(c)(2).

treatment with respect to their share ownership.²³⁶ QEF treatment ties the anti-deferral consequences to corporate profitability by causing the United States shareholder to include her pro rata share of the corporation's ordinary earnings and capital gains in income and characterizes the inclusion as ordinary income and capital gain according to corporate level treatment.²³⁷ The inclusion matches the United States tax impact of profitability to the year and character of corporate profit, rather than spreading excess distributions in level amounts over the shareholder's holding period and taxing them at the highest marginal rates as PFIC treatment requires.²³⁸ At the same time, United States owners of the foreign corporation may defer payment of the taxes on their shares of the corporation's earnings pending distribution but must pay interest on the deferred amounts.²³⁹

Yet, while the QEF election ameliorates many of the adverse consequences of PFIC classification to which the rabbi trust contributes, deferral of compensation nevertheless has an unfavorable effect on the shareholder's QEF inclusion in income. The corporation's ordinary earnings²⁴⁰ equals the excess of the corporation's current earnings and profits,²⁴¹ computed with certain adjustments,²⁴² over its net capital gain.²⁴³ Since United States tax principles control the computation of earnings and profits,²⁴⁴ deferral of compensation postpones the earnings and profits adjustment until the corporation is entitled to the deduction under United States law.²⁴⁵ Thus, deferral of compensation causes the foreign corporation to have more earnings and profits than it would have if the compensation expense were deductible under normal accrual principles, and each United States owner has a correspondingly greater QEF inclusion of the corporation's ordinary earnings.²⁴⁶

If at the same time as United States tax principles postpone the deduction for the deferred compensation, the foreign jurisdiction in which the corporation operates permits current deduction of the deferred compensation, that current deduction reduces the foreign taxes payable and the corresponding adjustment to

²³⁶Section 1295 provides for the election.

²³⁷I.R.C. § 1293(a).

²³⁸I.R.C. § 1291(a)(1).

²³⁹I.R.C. § 1294.

²⁴⁰I.R.C. § 1293(e)(1).

²⁴¹Section 312 describes the computation of earnings and profits.

²⁴²I.R.C. § 1293(e)(3).

²⁴³I.R.C. § 1222(11).

²⁴⁴Section 1293(e) implies application of United States rules to computation of earnings and profits. *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989), confirms this conclusion.

²⁴⁵I.R.C. § 404(a)(5).

²⁴⁶The computation of earnings and profits commences with taxable income under the taxpayer's usual method of accounting. Regs. § 1.312-6(a). See BITTKER & EUSTICE, *supra* note 60 ¶ 7.03.

earnings and profits.²⁴⁷ Thus, the mismatching of United States and foreign deductibility rules effectively increases the foreign corporation's earnings and profits and each United States owner's QEF inclusion.²⁴⁸

While, with exceptions,²⁴⁹ foreign corporations are not taxable on some United States source income,²⁵⁰ United States persons who are shareholders do not derive an antideferral rule benefit from the exclusion. For United States tax purposes, the nontaxable, United States source income, including both exemptions specific to foreign corporations²⁵¹ and tax exempt income such as municipal bond interest,²⁵² increase the foreign corporation's earnings and profits.²⁵³ Consequently, QEF electing United States shareholders must include their pro rata shares of the nontaxable United States income through the ordinary earnings inclusion because it is based on earnings and profits.²⁵⁴

If the compensation expense becomes deductible in a year in which the corporation has inadequate earnings and profits to absorb the corresponding compensation expense, earnings, and profits adjustment, the overinclusion of QEF ordinary earnings in the prior year permanently affects the United States owners adversely. No carryforward or carryback provision applies to deficits in earnings and profits. Timing of the compensation deduction becomes critical for foreign corporations with uneven income flow.

3. Foreign Personal Holding Companies

FPHCs are foreign corporations which meet annual income and share ownership tests.²⁵⁵ The corporation satisfies the income test if more than 60% (50% in any year following a year in which the corporation was a FPHC or in any of the

²⁴⁷Under section 164(a), foreign taxes are deductible in computing taxable income. While the result is the same, section 164(a) does not seem to be the correct provision for adjustment to earnings and profits. For the foreign corporation, its home country taxes should not be deductible since the home country taxes correspond to federal income taxes which are not deductible. I.R.C. § 275. Although federal income taxes are not deductible, a domestic corporation reduces its earnings and profits by the amount of federal income taxes it must pay because taxes diminish the corporation's ability to make distributions to shareholders. See BITTKER & EUSTICE, *supra* note 60 ¶ 7.03. In determining a foreign corporation's earnings and profits, its taxes payable to its home jurisdiction should play the same earnings and profits role as federal income taxes to a domestic corporation.

²⁴⁸Exchange rate variation also will affect United States owners as they translate the foreign items into United States dollars. This Article does not address the impact of exchange rates on the analysis.

²⁴⁹Not all foreign corporations qualify for the exemption from the gross base withholding tax on portfolio interest. See I.R.C. § 881(c)(3).

²⁵⁰Section 881(c)(1) and (d) exempt portfolio interest, interest on deposits, and certain dividends which are not effectively connected with a United States trade or business from the gross base withholding tax.

²⁵¹*Id.*

²⁵²I.R.C. § 103.

²⁵³Regs § 1.312-6(b).

²⁵⁴I.R.C. § 1293(a). Similar inclusion results to United States persons owning shares in CFCs and FPHCs. In fact, even if the foreign corporation is not a PFIC, distributions of United States sourced nontaxable income to United States persons who or which are shareholders will be dividends because of the increase to earnings and profits resulting from receipt of the income by the corporation.

²⁵⁵I.R.C. § 552(a).

three years following if the corporation was not a FPHC because it failed the income but not the share ownership test) of its gross income is FPHC income.²⁵⁶ FPHC income includes most passive types of income, interest, dividends, most rents, capital gains, income from certain shareholder use of corporate property, and income from certain personal service contracts.²⁵⁷ The corporation fulfills the share ownership test if five or fewer individual citizens or residents of the United States own more than half the voting power or value of all corporate shares.²⁵⁸ Constructive ownership rules apply to attribute share ownership from entities to their owners, to optionees, and among family members for purposes of the share ownership test.²⁵⁹

Each United States person who is a shareholder of a FPHC²⁶⁰ includes in his gross income annually as a dividend "the amount he would have received as a dividend" if the corporation had distributed all its undistributed foreign personal holding company income.²⁶¹ Undistributed FPHC income is the taxable income of the corporation, with certain adjustments.²⁶² For purposes of determining its taxable income, the corporation computes its gross income as if it were a domestic corporation, so the exclusions for foreign corporations are inapplicable.²⁶³ Although the corporation itself may be exempt from United States taxation because it has no United States source income other than excludable income,²⁶⁴ its worldwide income becomes part of its undistributed FPHC income. The income includes otherwise exempt income and its gain from sale or exchange of personal property that is free from United States tax because it is sourced outside the United States.²⁶⁵ Accordingly, from the United States shareholders' perspective, the funding of deferred compensation with a rabbi trust will cost them United States tax. The rabbi trust's income, also without regard to source or type, will be includable in undistributed foreign personal holding company income.²⁶⁶

In arriving at taxable income for purposes of the undistributed FPHC income computation, deferred compensation will not be deductible.²⁶⁷ If the deduction is not postponed for foreign tax purposes, the deduction for foreign taxes pay-

²⁵⁶I.R.C. § 552(a)(1).

²⁵⁷I.R.C. § 553(a).

²⁵⁸I.R.C. § 552(a)(2).

²⁵⁹I.R.C. § 554.

²⁶⁰I.R.C. § 551(a).

²⁶¹I.R.C. § 551(b). This provision implies two limitations on inclusion: (1) the shareholder's share of undistributed foreign personal holding company income; and (2) earnings and profits. The general rule of section 551(a) and regulations section 1.551-2 ignore the second limitation and include the shareholder's share of undistributed FPHC income without regard to the corporation's earnings and profits. *See also* BITTKER & LOKKEN, *supra* note 225 ¶ 68.3.

²⁶²I.R.C. § 556(a).

²⁶³I.R.C. § 555(a). The section 881(c) and (d) exclusions do not apply.

²⁶⁴I.R.C. § 881(c), (d).

²⁶⁵I.R.C. § 865.

²⁶⁶I.R.C. §§ 671, 555(a).

²⁶⁷I.R.C. § 404(a)(5).

able will also be smaller.²⁶⁸ So, in addition to including their shares of the rabbi trust's income, United States shareholders of FPHCs will suffer from postponing the deduction for deferred compensation. When the compensation becomes deductible, it will reduce undistributed FPHC income in the year of deduction, but the corporation will not be able to carry a deduction exceeding income (a resulting net operating loss) back to the earlier year of the deferral.²⁶⁹ And in computing undistributed FPHC income, the corporation may carry forward the net operating loss only one year.²⁷⁰ Moreover, the foreign corporation may not be a FPHC in the year of deduction,²⁷¹ so the United States shareholders may not benefit from the deduction at all.²⁷²

Other adjustments to taxable income resemble those which are made to taxable income in arriving at earnings and profits, but the correlation is imperfect.²⁷³ Exempt interest,²⁷⁴ for example, is excludable from undistributed FPHC income but not from earnings and profits.²⁷⁵ As a result, an electing shareholder's QEF inclusion, which is based on earnings and profits,²⁷⁶ may exceed the same shareholder's share of undistributed FPHC income when the corporation is both a PFIC and an FPHC. Thus, there will be a residue to include under the QEF rules after the initial inclusion by the shareholder of undistributed FPHC income.²⁷⁷

4. *Controlled Foreign Corporations*

Unlike United States shareholders of FPHCs who have to include their shares of undistributed FPHC income, which corresponds to all the foreign corporation's taxable income, as adjusted,²⁷⁸ United States shareholders of CFCs include only certain portions of the CFCs' income as dividend to them.²⁷⁹ United States taxpayers are taxable only on their shares of a CFC's subpart F income plus certain additions to investments.²⁸⁰ Consequently, if the deferred compensation relates to production of subpart F income,²⁸¹ postponement of the deduction for the compensation expense directly increases United States shareholders' subpart

²⁶⁸I.R.C. § 164(a).

²⁶⁹I.R.C. § 556(b)(4).

²⁷⁰I.R.C. § 556(b)(4).

²⁷¹A foreign corporation is tested each year to determine whether it is a FPHC. I.R.C. § 552(a).

²⁷²The shareholders may derive a benefit through the QEF inclusion if the corporation is also a PFIC. However, if it is not a FPHC under the income test of section 552(a)(1), it will fail to meet the PFIC income test as well. I.R.C. § 1297(a)(1).

²⁷³I.R.C. § 556(b). For example, special earnings and profits depreciation rules under section 312(k) do not apply.

²⁷⁴I.R.C. § 103.

²⁷⁵Regs. § 1.312-6(b).

²⁷⁶I.R.C. § 1293(a).

²⁷⁷Section 551(g) applies section 551(a) to income which would be included under both section 551 and section 1293.

²⁷⁸I.R.C. §§ 551(b), 556.

²⁷⁹I.R.C. § 951(a).

²⁸⁰I.R.C. § 951(a).

²⁸¹Subpart F income is defined in section 952 to include insurance income under section 953 and foreign base company income under section 954.

F inclusions by decreasing available deductions.²⁸² If the corporation is still a CFC when it pays the compensation, the deduction will reduce subpart F income and the United States shareholders' inclusion for that year.²⁸³ The corporation may carry forward the deduction, but not back, indefinitely whenever the deduction creates a deficit in earnings and profits.²⁸⁴ The carryforward deduction, however, may offset income only from the subpart F activity to which the deduction relates and not to any other of the corporation's subpart F activities.²⁸⁵ Whenever the deferred compensation is unrelated to the production of subpart F income, postponement of the corporation's deduction and a concomitant increase in income does not affect the United States shareholders' inclusion in income for United States tax purposes directly.

Indirectly, however, delay of the deduction for compensation affects United States shareholders in two ways. First, the postponement (less increased foreign taxes payable, if the foreign jurisdiction also postpones the deduction) increases corporate earnings and profits and the overall ceiling for subpart F income²⁸⁶ and consequently may increase the United States shareholders' subpart F inclusion.²⁸⁷ Second, the corporation invests the deferred compensation amount itself or through the rabbi trust. If invested through the rabbi trust, the foreign corporation will be the owner of the underlying investments for United States tax purposes because the trust is a grantor trust.²⁸⁸ In either event, directly or through the rabbi trust, the corporation owns the investments. Investments in United States property²⁸⁹ and in passive income generating assets may cause United States shareholders to include their pro rata shares of that investment, not only the income from it, in income.²⁹⁰ The effect of this rule is to include indirectly non-subpart F income in United States shareholders' incomes whenever the CFC neither distributes the income nor invests it in operating assets of the business.

Investments in United States property do not include financial institution deposits, corporate shares (unless the corporation and the CFC bear certain relationships to one another)²⁹¹, and various other property,²⁹² but the passive asset inclusion in shareholder income generally includes those properties excluded from the United States property definition.²⁹³ However, unless the corporation's passive assets exceed 25% of its total assets,²⁹⁴ there is no inclusion for the United States shareholders with respect to that property exempt from the United

²⁸²I.R.C. § 954(b)(5).

²⁸³I.R.C. § 954(b)(5).

²⁸⁴I.R.C. § 952(c)(1)(B)(i).

²⁸⁵I.R.C. § 952(c)(1)(B)(ii).

²⁸⁶I.R.C. § 952(c).

²⁸⁷I.R.C. § 951(a)(1).

²⁸⁸I.R.C. § 671.

²⁸⁹I.R.C. § 951(a)(1)(B). OBRA '93 amended sections 951(a) and 956 and added section 956A. Pub. L. No. 103-66, § 13231(a), 107 Stat. 312, 495 (1993).

²⁹⁰I.R.C. § 951(a)(1)(C)(as in effect for taxable years beginning after September 1993).

²⁹¹I.R.C. § 956(c)(2)(A), (F).

²⁹²I.R.C. § 956(b)(2).

²⁹³I.R.C. § 956A(c)(2).

²⁹⁴I.R.C. § 956A(c)(1).

States property definition.²⁹⁵

Both the investment in United States property and the excess passive assets inclusions adjust for investments which were previously taxed.²⁹⁶ Furthermore both these investment-based inclusions are limited to the amount of the foreign corporation's current and accumulated earnings and profits which the shareholders did not previously take into account.²⁹⁷ Thus, the postponement of the compensation deduction and foreign taxes payable influence the amount of this limitation in the same manner as, but less directly than, they affect the QEF inclusion for ordinary earnings of electing shareholders.²⁹⁸

Moreover, income from the invested amount is almost invariably passive and is part of the subpart F income which the United States shareholders must include in subsequent years.²⁹⁹ In contrast to the FPHC and QEF inclusions, exempt income, both generally exempt³⁰⁰ and specifically exempt for foreign corporations,³⁰¹ remain exempt from the FPHC income inclusion under the CFC rules.³⁰² FPHC income is that part of gross income consisting of passive-type income broadly defined.³⁰³ It becomes part of the subpart F income United States shareholders must include through its identity as one of the factors constituting foreign base company income.³⁰⁴ There are no comparable earnings and profits-based adjustments to the inclusion as there are for QEFs³⁰⁵ and for undistributed income for FPHCs.³⁰⁶

5. *The Deemed Paid Foreign Tax Credit*

Although not specific to rabbi trust applications, but exacerbated by them in some instances, the earnings and profits repercussions of compensation deferral may limit utility of foreign tax credits for United States corporations which are shareholders in foreign corporations. Specifically, the deemed paid foreign tax credit³⁰⁷ depends upon the interplay of the computation of earnings and profits with foreign taxes payable. Domestic corporations owning 10% or more of the voting stock of a foreign corporation are deemed to have paid that portion of the foreign corporation's taxes equal to the ratio of the dividends received by the domestic corporation from the foreign corporation to the foreign corporation's

²⁹⁵I.R.C. § 956A(a)(1)(A). The shareholder's share of excess passive assets will be zero.

²⁹⁶I.R.C. §§ 956(a)(1)(B), 959(c)(1)(A), 956A(a)(1)(B), and 959(c)(1)(B).

²⁹⁷I.R.C. §§ 956(a)(2), 956A(a)(2).

²⁹⁸See *supra* notes 240-46 and accompanying text (discussing the QEF ordinary earnings inclusion).

²⁹⁹One element of subpart F income is foreign base company income. I.R.C. § 952(a)(2). Foreign base company income includes in turn FPHC income, defined differently from the FPHC provisions of the Code, and is generally passive income including capital gains. I.R.C. § 954(a)(1), (c).

³⁰⁰I.R.C. § 103.

³⁰¹I.R.C. § 881(c), (d).

³⁰²I.R.C. § 954(c).

³⁰³I.R.C. § 954(c).

³⁰⁴I.R.C. § 954(a)(1).

³⁰⁵I.R.C. § 1293(e)(1).

³⁰⁶I.R.C. § 556(b).

³⁰⁷I.R.C. § 902.

earnings and profits.³⁰⁸

The obligation to pay deferred compensation limits the funds available for distribution to the shareholders. That same obligation to pay compensation in the future, unless pursuant to a qualified plan,³⁰⁹ is not a deductible expense in computing the foreign corporation's earnings and profits.³¹⁰ Relative to both accrual accounting principles and measurement of funds available for distribution to shareholders, the deferral of compensation results in overstatement of increases to earnings and profits in years from which compensation is deferred, and understatement in years in which the corporation pays the deferred compensation. When the corporation funds the deferral through a rabbi trust, it dedicates the trust's earnings to compensation as well. The corporation thereby increases the overstatement of earnings and profits in each year during the deferral period and further understates earnings and profits by the amount of the accumulated trust income at termination of the deferral period when the compensation expense becomes deductible.³¹¹

Assuming the compensation deferral is the only corporate transaction for which expense accrual and tax deduction do not match, the foreign corporation's distribution of all its available earnings during the compensation deferral period will not carry out the domestic corporate shareholder's full share of the foreign corporation's earnings and profits. Since the foreign corporation must reserve for the deferred compensation obligation, the ratio of the distribution to the overstated earnings and profits necessarily will be less than one. Funding the deferred compensation of the foreign corporation with a rabbi trust results in further increases to earnings and profits equal to the trust's income.³¹² Those earnings, attributed to the foreign corporation under United States tax principles, intensify the mismatch problem by further increasing the earnings and profits factor of the ratio. Accordingly, less than all the domestic corporation's share of the foreign corporation's foreign taxes will be creditable despite distribution of all available distributable funds. In addition, if the foreign taxing jurisdiction taxes the trust's earnings to the corporation, as the United States would in the case of a domestic corporation under the grantor trust rules,³¹³ the amount of the United States shareholder's share of those taxes grows each year and magnifies the potential exposure to excess foreign tax credit concerns discussed in the following examples.³¹⁴

Consider, for example, a foreign corporation having net income of \$150, foreign tax liability of \$50 on the \$150 of net income, direct earnings and profits correspondence, *i.e.*, \$100 of earnings and profits (\$150 earnings less \$50 taxes

³⁰⁸I.R.C. § 902(a).

³⁰⁹I.R.C. § 404(a)(5).

³¹⁰Regs. § 1.312-6(a).

³¹¹*Id.*

³¹²I.R.C. § 671; Regs. § 1.312-6(a).

³¹³I.R.C. § 671.

³¹⁴I.R.C. § 902.

payable³¹⁵), and \$50 of deferred compensation. If the foreign corporation has no other earnings and profits and distributes to its shareholders, including its 10% United States corporate shareholder, all its available income, the distribution will carry only one-half the domestic shareholder's share of the foreign taxes to the domestic shareholder. Available income is \$50, that is, \$150 net income less \$50 foreign taxes and \$50 reserve for deferred compensation. As a 10% shareholder, the domestic shareholder receives 10%, \$5, of the \$50 distribution. The ratio of the dividend distribution of \$5 to the foreign corporation's earnings and profits is 5/100 even though the corporation has distributed all it could, and the United States shareholder can claim a foreign tax credit for only \$2.50, rather than \$5 which would be the domestic shareholder's share of all the \$50 of foreign taxes. Since the foreign corporation has nothing more to distribute, the remainder of the domestic shareholder's share in the foreign taxes remains trapped in the foreign corporation, and the domestic shareholder is unable to derive a tax credit benefit from it.

Unlike the problem for shareholders in the QEF, a subsequent earnings and profits deficit created by payment of the deferred compensation will not necessarily go to waste. The deficit will reduce future accumulations of earnings and profits. Distributions to the domestic shareholder following payment of deferred compensation will carry to the shareholder a disproportionately large share of foreign taxes, as the earlier distribution drew a disproportionately small share of the foreign taxes in the example of the preceding paragraph. Unless the foreign tax rate is much lower than the United States rate, however, the domestic shareholder may find itself in an excess foreign tax credit position. The amount of the distribution to which the foreign taxes attach is likely to be too small relative to the domestic corporation's income to permit utilization of the full foreign tax credit.³¹⁶ If the termination of the compensation deferral and subsequent distribution occur within two years of the earlier distribution, it may be possible to carry back the excess foreign taxes to the earlier distribution.³¹⁷ If not possible, the excess foreign tax credit may be permanent and unusable, as additional foreign taxes in all likelihood will accompany future distributions to the domestic shareholder within the five-year carryforward period.³¹⁸

V. CONCLUSION

This Article has presented an algebraic method and theorem for determining the circumstances under which deferral of compensation benefits the employee. The method demonstrates that most reasonable assumptions concerning tax rates suggest that, considering economic aspects, only the employee of the deferral

³¹⁵Section 164(a) permits a deduction for foreign taxes.

³¹⁶I.R.C. § 904. In fact, section 902 deemed paid taxes are creditable only with respect to section 902 distributions, because there is a separate limitation under section 904(d)(1)(E).

³¹⁷I.R.C. § 904(c).

³¹⁸I.R.C. § 904(c). Section 902 continues to carry foreign taxes to the domestic shareholder as the foreign corporation pays them and makes distributions to its shareholders.

should elect to defer whenever he or she has the choice.

Given that deferral preference, the Article examined the impact on the employee and the employer of nonqualified, deferred compensation arrangements funded with rabbi trusts. In the course of that examination, the Article identified especially attractive planning opportunities for utilization of such trusts by offshore employers for their United States citizen or resident employees. When specific employee and employer characteristics coincide, the deferred compensation amounts offer the employee, for whose benefit they are reserved, investment advantages both in the United States and offshore which would not be available to the employee investing directly.

Finally, the Article presented an overview of the interplay between deferral of compensation, with and without funding through a rabbi trust, for offshore employers engaged in United States trades or businesses and offshore employers having United States persons as owners. Hazards of compensation deferral for the employer and its owners include potential loss of tax benefits from the compensation expense deduction when the employee ultimately receives the compensation. Loss of tax benefits appears in the form of both overinclusion of income from the foreign entity, but no underinclusion in the year of payment, and loss of foreign tax credits. Thus, while deferral of compensation generally benefits the employee and may provide especially attractive benefits in certain offshore applications, it also may become especially disadvantageous to the United States owners of certain foreign entities.

