

**PRESENT LAW AND ANALYSIS  
RELATING TO SELECTED INTERNATIONAL TAX ISSUES**

Scheduled for a Public Hearing  
Before the  
SENATE COMMITTEE ON FINANCE  
on September 26, 2007

Prepared by the Staff  
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## INTRODUCTION AND SUMMARY

The Senate Committee on Finance has scheduled a public hearing on selected international tax issues on September 26, 2007. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, includes a description of present law and analysis of Federal tax issues relating to offshore reinsurance, offshore entities as investment vehicles for tax-exempt investors, and offshore entities as vehicles for deferral of certain types of compensation.

Part One of this document provides background information about offshore reinsurance and about use of offshore entities by investment funds in connection with tax-exempt investors and for deferral of income of fund managers. Part Two describes present law relating to Federal income tax treatment of insurance companies, the excise tax applicable to premiums paid to foreign insurers and reinsurers covering U.S. risks, applicable international tax rules under U.S. Federal tax law and international tax treaties, unrelated business income tax and debt-financed income, and an overview of ways to defer services income. Part Three provides a description of legislative proposals in recent Congresses relating to offshore reinsurance. Part Four provides a discussion of issues and analysis relating to offshore reinsurance, unrelated business income tax and debt-financed income, and nonqualified deferred compensation.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, “*Present Law and Analysis Relating to Selected International Tax Issues*” (JCX-85-07), September 24, 2007. This document is available on the internet at [www.house.gov/jct](http://www.house.gov/jct).

## I. BACKGROUND

### Offshore reinsurance

#### In general

Insurance company reinsurance transactions with offshore reinsurers, particularly affiliated reinsurers, have been characterized as creating the potential for tax avoidance and as causing a competitive disadvantage for U.S. insurance businesses. At the same time, reinsurance is a fundamental component of global risk management techniques.

Insurance transactions are characterized by risk shifting and risk distribution.<sup>2</sup> Risk shifting means transferring the risk from one person to another person. Risk distribution means spreading risks among a pool or group of persons.

Insurance is a specific mechanism for transferring the financial consequences associated with the occurrence of identifiable but uncertain (“fortuitous”) adverse events (e.g., the risk of damaging one’s automobile in an accident, the risk of fire damaging one’s home, or the risk of dying prematurely). The concept of risk shifting is best understood from the perspective of the insured: it contemplates that the insured shifts to another person the financial consequences of the adverse fortuitous events, so that (at least to the extent of the insurance) the occurrence of the event has no direct financial impact on the insured. Thus, self-insurance generally is not insurance in the tax sense, because the insured retains the financial consequences that follow from the occurrence of the adverse fortuity.

Many financial contracts – for example, many derivative contracts – shift risk between parties, but that fact does not mean that those contracts necessarily constitute insurance, because the other critical component of true insurance – risk distribution – typically is not present. Just as risk shifting is most easily understood when viewed from the perspective of the insured, risk distribution is a concept that is best visualized from the perspective of the insurer. Risk distribution refers to the fact that, in entering into any one line of the insurance business (such as automobile liability insurance or health insurance), insurers assume or underwrite numerous individual risks that, at least ideally, are independent but homogeneous. Risks are independent when the occurrence of one adverse event in the pool of risks held by the insurer does not increase the likelihood that the other adverse fortuities in the pool will occur. Risks are homogeneous when they are similar in nature. When an issuer has a sufficiently large pool of independent but homogeneous risks, it can rely on the law of large numbers – a statistical tool that enables insurers to model with a relatively high degree of confidence the pattern of actual losses that it can expect in each period. Risk distribution and the associated application of the law of large numbers can be understood in a general sense as the core mechanism by which insurers manage their underwriting risks (i.e., the risk of paying claims arising from insured events), as contrasted with the insurer’s investment risks.

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<sup>2</sup> *Helvering v. LeGierse*, 312 U.S. 531 (1941).

When the conditions of risk shifting and risk distribution are satisfied, the insurer can price the premiums it charges to reflect with some precision the total losses it expects from the relevant pool of risks in each period. For example, when an individual buys automobile collision insurance, he shifts from himself to the insurer the risk of paying for damages sustained by his automobile as a result of an accident. The insurer in turn manages that risk by pooling it with other similar automobile insurance contracts that it writes. In this way, each customer (through the premiums that he pays) effectively pays for a portion of the damages sustained by all the automobiles in the pool: because most people are risk averse, they prefer in effect to suffer small but definite losses (the premiums they pay) to unpredictable but much larger losses (the financial consequences of a loss event if one were self-insured).

Insurance covers a variety of types of risks, which are grouped by line of business under current industry practice and regulatory reporting rules. Some lines of business are paid out relatively promptly following the time when the risk is incurred, such as health insurance and automobile liability; these are known as short-tail lines of business. Other lines of business are characterized by longer pay-out periods, such as medical malpractice and workers compensation; these are known as long-tail lines of business.<sup>3</sup>

Insurance companies are regulated by State insurance regulators in the States in which they do business. State regulators look to the National Association of Insurance Commissioners (the NAIC) for recommendations on regulatory and reporting standards. State insurance rules require annual financial reporting by insurers in accordance with a conservative accounting method known as “statutory accounting,” which is designed to maintain insurer solvency.

### Types of reinsurance

Reinsurance is a form of further risk shifting and risk distribution. Reinsurance is sometimes characterized as insurance for insurers. A reinsurance transaction is an agreement between insurance companies to pass a risk, or a block of risks, from one company to the other company. Risks can be subdivided and portions reinsured. For example, a portion of the risk may consist of a specific dollar amount such as a layer or band of the total dollar amount, the excess over a dollar amount, or a percentage of the total dollar amount of the risk.

Risks can be reinsured singly or in groups. “Facultative” reinsurance covers a specific risk and is separately negotiated, often because the risk is specialized, high-hazard, or extraordinarily large. A reinsurance “treaty” generally covers a block of risks or type of risks. Under a reinsurance treaty, the primary insurer and the reinsurer agree that all or a specified portion of the primary insurer’s business or policies of a particular type or types are covered automatically by the reinsurer until the agreement is terminated.

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<sup>3</sup> During the first years following the year of coverage, long-tail lines of business tend to have a relatively high proportion of unpaid losses, including losses that are incurred but not reported during the year, whether due to nonobservance of the event of loss, nonreporting of the claim, litigation, or other reasons.

The portion of a risk covered under a reinsurance agreement can be determined in a variety of ways. Proportional, or pro rata, reinsurance can be on a “quota share” basis, that is, a set percentage of premiums received and losses covered for the applicable risks. Alternatively, proportional reinsurance can be on a “surplus share” basis, that is, an agreed dollar amount of premiums received and losses covered for the applicable risks. Non-proportional reinsurance is known as “excess of loss,” representing the reinsurer’s coverage for losses above the primary insurer’s retention amount. Excess of loss coverage can be on an individual risk basis, on an occurrence basis (relating to the occurrence of a particular event such as a storm or earthquake), or on an aggregate basis (covering losses above a dollar amount per policy or per year).

### Alternatives to reinsurance

A number of alternatives to reinsurance transactions may also be used to shift and distribute risks. These alternatives comprise the “alternative risk transfer” or ART markets and products. These markets and products can become more attractive when reinsurance prices rise, for example,<sup>4</sup> and can serve financing, hedging, or other financial purposes as well as more traditional risk management goals.

There is no generally accepted definition of what constitutes an ART product, and the ART marketplace continues rapidly to evolve. The term has been applied to arrangements as diverse as self-insurance, captive insurance, sidecar reinsurance, finite risk insurance or reinsurance, capital markets financings such as catastrophe (“cat”) bonds, and weather derivative contracts.<sup>5</sup> Some ART products (e.g., captive insurance and finite risk insurance) typically are structured with a purpose to constitute insurance under State regulatory rules. Others, such as cat bonds, are not treated as insurance for regulatory purposes.

The characterization for Federal income tax purposes of ART products as insurance, or as some other financial product, may not be clear in all cases. Some ART products involve risk shifting, but not necessarily risk distribution. Other ART products, including many that are analyzed as insurance for regulatory purposes, raise questions of whether the product embodies sufficient risk shifting and risk distribution that it should be treated as insurance for Federal income tax purposes.<sup>6</sup>

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<sup>4</sup> The property and casualty insurance industry has historically been cyclical, involving increases and declines in prices that are known as “hardening” and “softening” insurance markets. See, e.g., “Rate Hardening Forces Growth in Captive Market, Aon Says,” *Reactions Weekly News*, Dec. 2, 2005; “Cat Bonds Benefit from Rate Hike,” *Reactions Magazine*, Feb. 2002.

<sup>5</sup> See Peter A. Gentile, Spencer M. Gluck, Peter Senak, and Jeffrey M. Stewart, *Modern ART Practice*, Gerling Global Financial Products 2000; Thomas Holzheu, “Alternative Risk Transfer (ART) Products,” in *Reinsurance: Fundamentals and New Challenges* (ed. Ruth Gastel), Insurance Information Institute (2004), 113-124; “The Picture of ART,” *Sigma*, Swiss Reinsurance Company Economic Research and Consulting (2003).

<sup>6</sup> Two examples of the difficulties posed to the tax system by ART insurance products are finite risk insurance and captive insurance. Finite risk insurance for this purpose can be understood as a contractual arrangement whose returns predominantly reflect standard financial market terms (e.g., the

## Reasons for engaging in reinsurance transactions

Primary insurers have a variety of reasons for reinsuring some of their business. A principal reason is to shift risk, just as any other insured does, because an insurer's pool of risks is too concentrated in some fashion. For example, the primary insurer's risk pool may fall unacceptably short of the goal of homogeneity.

Another reason relates to regulatory compliance. State insurance rules generally require that an insurance company maintain "surplus," and the States limit the amount of new business the company can write based on a ratio of net premiums to surplus. Reinsuring some of the company's risks can lower the ratio of net premiums<sup>7</sup> to surplus and allow the company to write more insurance. Thus, reinsurance can serve in effect as a form of financing for growth in the primary insurance company's business.

A reinsurance transaction can also function as a business acquisition technique for the reinsurer. By reinsuring a block of business, for example, a reinsurer can enter a new line of business more easily than by directly writing policies in that line of business. Similarly, a primary insurer can divest itself of a line of business by reinsuring its entire book of business in that line.<sup>8</sup>

Several related risk management and financial reporting concerns also motivate the use of reinsurance. A primary insurer can use reinsurance to reduce exposure to extremely large losses from one source such as a catastrophic event (for example, a hurricane) or a particular environmental hazard (for example, asbestos). By reinsuring amounts above a certain level, the

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time value of money), but which also embody just enough insurance underwriting risk as to be treated as insurance for at least some regulatory purposes. Captive insurance arrangements generally refer to instances in which (typically) a non-insurance company establishes an insurance subsidiary (often in Bermuda or another offshore location) to insure risks of the U.S. parent and other subsidiaries. The Internal Revenue Service has extensively litigated the tax status of various captive insurance or reinsurance vehicles (see cases at note 193, below). The IRS's original theory was that these arrangements did not constitute insurance in the tax sense, because the parent's ownership of the captive subsidiary meant that losses absorbed by the subsidiary ultimately were borne by the parent, as the owner of the insurance subsidiary's equity, and therefore no risk shifting occurred, and because there was no pooling of risks from outside of the affiliated group of companies. This analysis was described as the "economic family" theory. More recently, the IRS announced that, because no court had to that date wholly adopted the economic family theory, the Service would abandon that argument, although it would continue to challenge particular arrangements that in its view did not satisfy the risk shifting or risk distribution test.

<sup>7</sup> The amount of net premiums for this purpose is determined net of premiums ceded to a reinsurer. Under State regulation, a ceding company treats amounts due from reinsurers as assets or reductions of liability, an accounting practice known as credit for reinsurance. See Joseph Sieverling and Scott Williamson, "The U.S. Reinsurance Market," in *Reinsurance: Fundamentals and New Challenges* (ed. Ruth Gastel), Insurance Information Institute (2004) at 126.

<sup>8</sup> See Donald A. McIsaac and David F. Babbel, "The World Bank Primer on Reinsurance," *Policy Research Working Paper 1512*, The World Bank (1995).

primary insurer can smooth loss payments over the year or between years. This can reduce volatility in the company's earnings.

Reinsurance can have U.S. tax benefits as well as book or financial benefits. In general, premiums ceded for reinsurance are deductible in determining a company's Federal income tax.<sup>9</sup> If the transaction effects a transfer of reserves and reserve assets to the reinsurer, the tax liability for earnings on those assets generally is shifted to the reinsurer as well. If earnings on these assets are shifted to a reinsurer in a no- or low-tax foreign jurisdiction, generally these earnings are not subject to income taxation.

#### Federal tax issues relating to offshore reinsurance

The transfer of U.S. risks to foreign reinsurers in low-tax or no-tax jurisdictions, whether by corporate expatriations, foreign acquisitions, or by reinsurance transactions to affiliates and third-party reinsurers, has been criticized as causing a tax-induced competitive disadvantage for U.S. insurers and reinsurers.<sup>10</sup> The issue has been publicized repeatedly in recent years<sup>11</sup> despite 2004 changes in the Federal tax law to limit the tax benefit of "inversions"<sup>12</sup> – expatriation of a U.S. corporation or partnership to a foreign jurisdiction – and to strengthen the Treasury Department's regulatory authority to reallocate items in reinsurance arrangements.<sup>13</sup> Though these changes may have made some types of transactions transferring U.S. risks to foreign reinsurers less attractive to a U.S. insurer from a tax planning standpoint, reinsurance with offshore reinsurers has remained strong.<sup>14</sup>

Insuring risks with captive insurance affiliates generally can have the effect of reducing U.S. tax on certain earnings. Because of tax accounting rules applicable to insurance companies, under which additions to insurance reserves are deductible, investment earnings on insurance

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<sup>9</sup> Sec. 832(b)(4).

<sup>10</sup> See Jon Almeras and Ryan J. Donmoyer, "Insurers Approach Congress to Fix 'Bermuda Loophole,'" 86 *Tax Notes* 1660, Mar. 20, 2000; Lee A. Sheppard, "News Analysis – Would Imputed Income Prevent Escape to Bermuda?," 86 *Tax Notes* 1663, Mar. 20, 2000.

<sup>11</sup> Susanne Sclafane, "U.S. CEO on a Mission to Tax Bermuda Competitors," *National Underwriter Online News Service*, Nov. 20, 2006; Susanne Sclafane, "Bermuda CEO Fights Back on Tax Issue," *National Underwriter Online News Service*, Nov. 21, 2006.

<sup>12</sup> Section 7874, imposing income U.S. tax on certain income and gain of expatriated entities and their foreign parents, was enacted in section 801 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357. This provision is described in the section of this document entitled International Taxation.

<sup>13</sup> Section 845, providing authority to the Treasury Department for allocation in the case of a reinsurance agreement involving tax avoidance or evasion, was enacted in 1984 and was modified by section 803 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357. This provision is described in the section of this document entitled Federal Income Tax Treatment of Insurance Companies.

<sup>14</sup> See below, Mark E. Ruquet, "Bermuda Reinsurers Had Record 2006 Results," *National Underwriter On-Line News Service*, March 23, 2007.

company reserves can be viewed as tax-favored.<sup>15</sup> The use of captive insurers as well as the use of affiliated reinsurers are thought to be a means by which U.S. insurance risks migrate to offshore reinsurance markets.

Reinsurance can provide a tax benefit to the primary insurer of U.S. risks principally by shifting to the reinsurer the tax liability for earnings on reserves, that is, on investment assets that fund the future payment of insurance claims.<sup>16</sup> In the case of reinsurance with an unrelated or third-party reinsurer, this tax benefit is counterbalanced by the yielding of the business opportunity for profit on the reinsured risks to that unrelated reinsurer.

The tax benefit of reinsurance can be duplicated without yielding the business to a third party, however, if the reinsurer is a foreign affiliate. The corporate structure under which earnings on U.S. risks reinsured with an affiliate are treated as not subject to U.S. tax involves the use of a parent corporation in a low-tax or no-tax foreign jurisdiction. The foreign parent's subsidiaries include both the primary insurer, a U.S. corporation, and the reinsurer, also a foreign corporation in a low-tax or no-tax jurisdiction. The primary insurer of the U.S. risks engages in a reinsurance transaction with the foreign affiliate, shifting the reserve assets to the foreign affiliate. The earnings on the reserve assets associated with the reinsured risks are shifted outside the U.S. tax system. Present-law U.S. tax rules such as the Subpart F rules requiring current inclusion of certain income for U.S. shareholders, the "toll charge" for certain outbound transactions under section 367, and the inversion rules of section 7874,<sup>17</sup> generally do not apply to the transaction, although the Treasury Department has the authority to reallocate items under section 482 or section 845, and the one-percent reinsurance excise tax applies.<sup>18</sup> The tax benefit of such reinsurance with a foreign affiliate is greater for long-tail lines of business that tend to require reserve assets to be maintained for a longer period of time than for short-tail lines of business.

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<sup>15</sup> Discounting rules applicable to tax reserves of property and casualty insurance companies partially take account of the time value of money (sec. 846). These rules are described in the section of this document entitled Present Law - Federal Income Taxation of Insurance Companies.

<sup>16</sup> In addition, premiums paid by property and casualty insurers for reinsurance generally are deductible (sec. 832(b)(4)(A)), though there may be offsetting income items depending on the nature of the reinsurance transaction.

<sup>17</sup> Before the enactment of section 7874 in 2004, some U.S. insurers took the position that they were not precluded from expatriation transactions, and structures with foreign parent corporations in low-tax or no-tax jurisdictions were set up. Although the opportunity to set up such corporate structures has been limited by the enactment of section 7874, the pre-2004 structures are already in place and are used for these related-party reinsurance transactions. By contrast, U.S. insurers that did not engage in inversion transactions before the 2004 legislation, perhaps because they would have had a high tax cost imposed on the transaction under the section 367 toll charge on low-basis, long-held corporate assets, do not have this structure in place.

<sup>18</sup> These present-law rules are described in the section of this pamphlet entitled Present Law - Reinsurance Excise Tax. Issues raised by these arrangements are discussed in the section of this pamphlet entitled Issues and Analysis.

## Property and casualty insurance industry and reinsurance markets

Property and casualty insurers operating in the U.S. recorded \$499 billion in directly written premiums in 2006. Such insurers ceded reinsurance of \$340 billion to affiliates, and \$64 billion to non-affiliates, while assuming \$310 billion of reinsurance from affiliates and \$48 billion from non-affiliates. Thus, net premiums written totaled \$453 billion.<sup>19</sup> Since 1998, net premiums written have increased at an annualized rate of 6.0 percent, compared to an annualized rate of 3.6 percent between 1987 and 1997. Assets of these insurers totaled \$1,671 billion in 2006, and grew at an annualized rate of six percent from 1998 to 2006, compared to an annualized rate of eight percent from 1987 to 1997.<sup>20</sup>

Over the recent past, U.S. property and casualty insurers have increased both the amount of reinsurance assumed and ceded, both in absolute terms and relative to direct premiums written. In 2006 the amount of assumed reinsurance, as noted above, was an amount equal to 71.7 percent of direct premiums. Ceded reinsurance equaled 80.9 percent of direct written premiums. In 1990, in comparison, U.S. property and casualty insurers assumed reinsurance in amounts equal to 60.5 percent of direct written premiums, and ceded reinsurance in amounts equal to 66.0 percent of direct written premiums.<sup>21</sup>

While there has been growth in both assumed and ceded reinsurance, reinsurance assumed and ceded with respect to non-affiliates has declined relative to direct premiums written. Reinsurance assumed from non-affiliates has fallen from an amount equaling 12.2 percent of direct premiums in 1990 to an amount equal to 9.6 percent of direct premiums in 2006, and reinsurance ceded to non-affiliates has fallen over the same period from an amount equal to 16.5 percent of direct premiums to 12.7 percent of direct premiums. In contrast, reinsurance assumed from affiliates grew over that period from an amount equal to 48.4 percent of direct premiums in 1990 to an amount equal to 62.1 percent in 2006, while insurance ceded to affiliates over the same period grew from an amount equal to 49.5 percent of direct premiums to an amount equal to 68.2 percent of direct premiums.<sup>22</sup>

With respect to insurance ceded to offshore reinsurers, according to the Reinsurance Association of America, \$54.7 billion of U.S. premiums were ceded to offshore reinsurers in 2006, \$22.2 billion of which was ceded to unaffiliated offshore reinsurers and \$32.5 billion of which was ceded to affiliated offshore reinsurers. These amounts compare to approximately \$37.3 billion ceded to offshore reinsurers in 2001, \$21.5 billion of which was ceded to

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<sup>19</sup> A.M. Best Company, “Best’s Aggregates and Averages, Property/Casualty, United States and Canada,” 2007 edition, at 162.

<sup>20</sup> *Id.* at 409, and calculations of the staff of the Joint Committee on Taxation.

<sup>21</sup> A.M. Best Company, “Best’s Aggregates and Averages, Property/Casualty, United States and Canada,” 1991 edition, at 82.

<sup>22</sup> A.M. Best Company, “Best’s Aggregates and Averages, Property/Casualty, United States and Canada,” 1991 and 2007 editions, at 82 and 162 respectively, and calculations of the staff of the Joint Committee on Taxation.

unaffiliated offshore reinsurers and \$15.9 billion of which was ceded to affiliated offshore reinsurers. Hence from 2001 to 2006, total premiums ceded to offshore reinsurers grew by 46.7 percent, of which premiums ceded to unaffiliated offshore reinsurers grew by 4.7 percent and premiums ceded to affiliated offshore reinsurers grew by 104.4 percent.<sup>23</sup>

Markets for reinsurance have become global. Historically, London has been an insurance and reinsurance center. Very large reinsurers are also located in Germany and Switzerland. Bermuda is an increasingly large global reinsurance market.<sup>24</sup> Between 1983 and 2001, net premiums written in the Bermuda insurance market grew from \$4.7 billion to \$41.4 billion, and total assets in the Bermuda insurance market grew from \$17.1 billion to \$172.7 billion.<sup>25</sup> It is reported that capital grew 24 percent to \$65 billion in 2006 among a group of Bermuda reinsurers, a doubling in their capital since 2002.<sup>26</sup> Bermuda is considered to have insurance regulatory rules favorable to insurance companies and products, and does not impose a corporate income tax.<sup>27</sup>

### **Use of offshore entities by investment funds**

#### **In general**

Over the past several decades, private equity funds, venture capital funds, hedge funds, and similar alternative investment vehicles<sup>28</sup> that are managed by U.S. fund managers have attracted large amounts of investment capital. Investors in these funds often include institutional investors such as pension funds and educational and charitable institution endowments, and wealthy individual investors. These investors become limited partners in the funds, which are generally structured as partnerships. Some investment funds are established in offshore jurisdictions,<sup>29</sup> particularly those offshore jurisdictions that impose no (or little) income tax. The

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<sup>23</sup> Reinsurance Association of America, "Offshore Reinsurance in the U.S. Market, 2006 Data," and calculations of the staff of the Joint Committee on Taxation.

<sup>24</sup> See "Is Lloyd's Losing Out to Bermuda?," *Reactions Weekly News*, Aug. 1, 2002.

<sup>25</sup> See David Fox, "The Bermuda Market," in *Reinsurance: Fundamentals and New Challenges* (ed. Ruth Gastel), Insurance Information Institute (2004) at 137.

<sup>26</sup> Mark E. Ruquet, "Bermuda Reinsurers Had Record 2006 Results," *National Underwriter On-Line News Service*, March 23, 2007.

<sup>27</sup> See, e.g., *id.* at 140; Robert L. Carter and Leslie D. Lucas, *Reinsurance Essentials*, Reactions Publishing Group, 2004, at 256.

<sup>28</sup> These types of funds have differing investment strategies. These are briefly described in the Economic Data section of *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. This document is available on the internet at [www.house.gov/jct](http://www.house.gov/jct).

<sup>29</sup> Some offshore entities are established in foreign jurisdictions that imposed very little or no income tax on investment activities of firms domiciled there. The Cayman Islands and Bermuda are

assets invested in the funds generally are managed by groups of individuals who contribute a relatively small amount of capital to the fund (in relation to amounts of capital contributed by the investors) and who provide investment expertise in selecting, managing, and disposing of fund assets.

Investors in the funds have historically (though not exclusively) been of three general types: high net-worth individuals who are subject to U.S. tax; foreign persons who are not otherwise subject to U.S. tax; and U.S. institutional investors (such as charities and private and government pension funds) that are tax-exempt under U.S. tax rules.<sup>30</sup> These types of investors have differing U.S. tax situations, and therefore, confront differing tax issues when they invest in investment funds such as hedge funds and private equity funds.

In general, U.S. high net-worth individuals may be concerned about limitations on deductions, such as the 2-percent floor on miscellaneous itemized deductions, the overall limitation on itemized deductions, and the alternative minimum tax. They may prefer to let the fund manager's carried interest serve to reduce their distributive share of partnership income as it is earned, rather than having a higher share of partnership income along with a deduction for manager compensation that may not be fully or currently usable because of a deduction limitation. These individual investors may also be sensitive to the rate differential between long-term capital gain and qualified dividend income, on the one hand, and other forms of investment returns, on the other hand.

Tax-exempt organizations and foreign persons not subject to U.S. tax may be indifferent to deductions. Instead, tax-exempt organizations may be concerned about becoming subject to unrelated business income tax.

Foreign investors may be concerned about becoming subject to U.S. net income tax or U.S. withholding tax.<sup>31</sup> Foreign investors may prefer not to have to file a U.S. income tax return (even if no tax is ultimately due).

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examples of such jurisdictions. See Lynnley Browning, "A Hamptons for Hedge Funds: Offshore Tax Breaks Lure Money Managers," *New York Times*, July 1, 2007.

<sup>30</sup> There are also other types of investors, including corporations subject to U.S. tax, and funds of funds. See the Economic Data section of *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. This document is available on the internet at [www.house.gov/jct](http://www.house.gov/jct).

<sup>31</sup> Investors have sought to avoid U.S. withholding tax by holding instruments that replicate the returns on stocks but that the investors have treated as notional principal contracts. The source of income from notional principal contracts is determined by the residence of the recipient of the income. A non-U.S. person's income from notional principal contracts therefore is foreign source and is not subject to U.S. withholding tax. See Treas. Reg. sec. 1.863-7(b)(1); Anita Raghavan, "Happy Returns: How Lehman Sold Plan to Sidestep Tax Man," *Wall St. Journal*, Sept. 17, 2007; David P. Hariton, "Equity Derivatives, Inbound Capital and Outbound Withholding Tax," 60 *Tax Lawyer* 313 (2007).

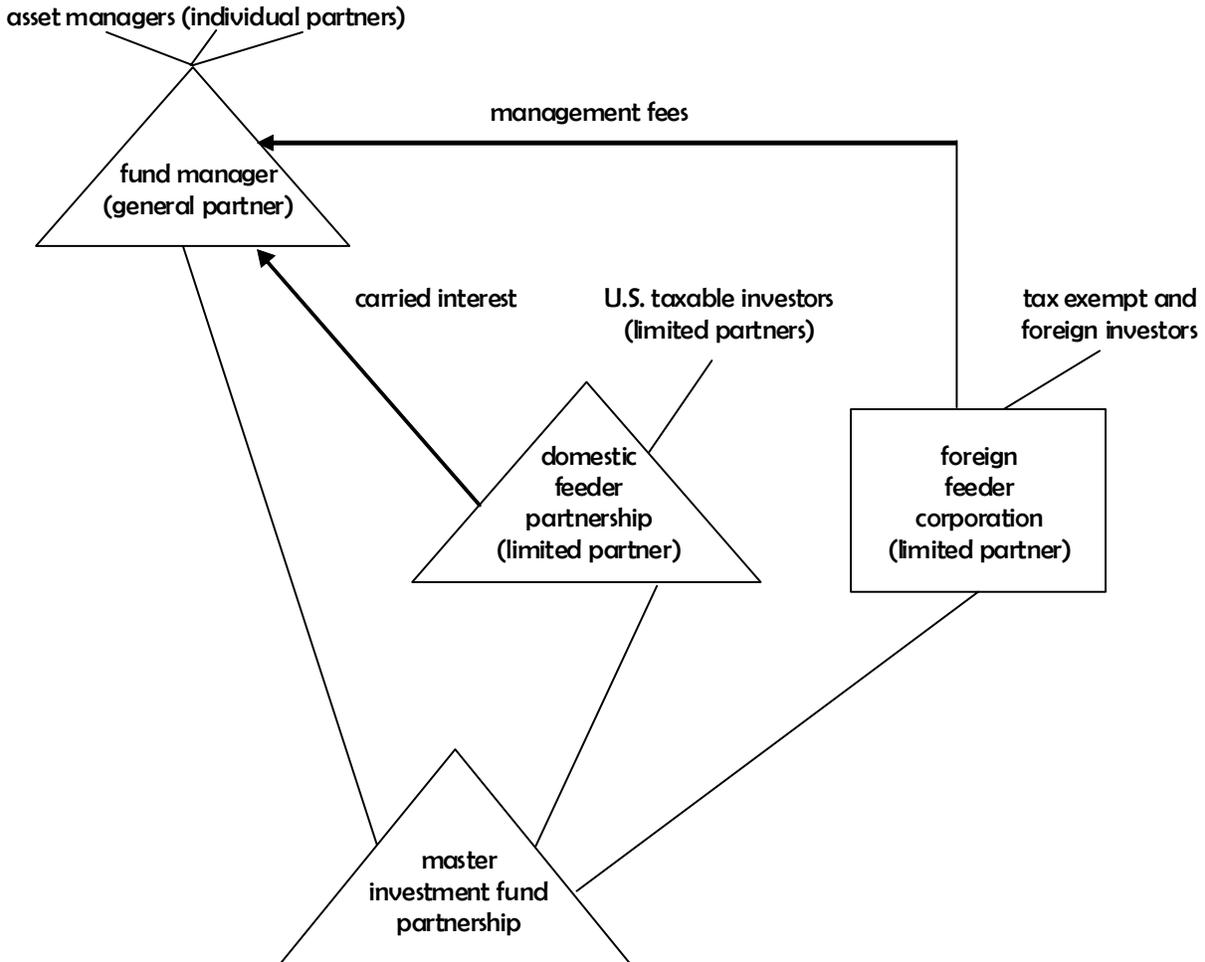
Funds have been structured to accommodate these various concerns, and to maximize aggregate tax savings with respect to all the parties (investors and fund managers). These arrangements may be based on the “master-feeder” structure, in which a single fund is held by separate domestic and foreign entities through which different types of investors invest.<sup>32</sup> The structure may include the interposition of a foreign corporation – a “blocker” corporation – between the investment fund and certain of its investors, typically the fund’s foreign and tax-exempt investors, which serves to block types of income received that could be subject to U.S. tax in their hands, and to convert this income into dividends (or interest) when distributed to them.<sup>33</sup> The foreign corporation may also serve as an income deferral mechanism for individual fund managers in the case of management fees.

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<sup>32</sup> A variant involves the use of parallel U.S. and foreign funds with substantially similar investments. The master-feeder structure is described in the Background section of *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. This document is available on the internet at [www.house.gov/jct](http://www.house.gov/jct).

<sup>33</sup> So-called blocker corporations can be used in different contexts, and for different purposes. For example, a publicly-traded partnership might use a lower-tier blocker corporation to earn income (such as fee income) of a type that would otherwise disqualify the publicly-traded partnership from its status as a partnership (rather than a corporation) for tax purposes. Similarly, an offshore hedge fund or other alternative investment fund might use an offshore upstream (or “feeder”) blocker corporation as an intermediate holding company through which U.S. tax exempt institutions can invest indirectly in the underlying investment fund. In both cases, though, the affairs of the blocker corporation ordinarily are managed to minimize its U.S. taxable income. In the publicly-traded partnership case, for example, the blocker corporation might be funded by the publicly-traded partnership with debt capital, the interest on which would be sufficient to eliminate most or all of the blocker corporation's income; at the same time, the interest income, when received by the publicly-traded partnership, would be treated as qualifying income for purposes of its status as a partnership for tax purposes. In addition (or alternatively), the lower-tier blocker corporation might be the member of the publicly-traded partnership's group of affiliates that holds amortizable intangible assets generating substantial tax deductions (but not cash outlays). In the offshore hedge fund case, the blocker corporation itself typically would be a foreign corporation that is treated as not engaged in a U.S. trade or business (and therefore is not subject to U.S. net income tax), by virtue of the securities trading “safe harbor” of section 864(b). In both cases, the end result is the same: the blocker corporation serves to “cleanse” tainted income at minimal U.S. tax cost.

## Investment Fund Structure with Foreign Feeder Corporation



### Reasons for selecting offshore entities

An initial issue involves identifying which aspects of the structure and business activities of hedge funds and private equity funds and their managers are offshore, and which aspects remain onshore in the United States. Use of intermediate foreign corporations is relatively common. Sometimes the investment fund itself is established offshore.<sup>34</sup> Generally the foreign corporation or entity is established in a jurisdiction that does not impose an income tax, or imposes very little tax.

Foreign individuals may find it attractive to invest in an alternative asset fund through an offshore corporation rather than directly because by doing so, the individuals may avoid the direct imposition of U.S. tax on income effectively connected with a U.S. trade or business and the concomitant requirement to file a U.S. tax return. Foreign individuals may also hold the

<sup>34</sup> In some cases, the offshore investment fund is one of two parallel investment funds, the other of which is established in the United States.

view that it is preferable to invest through a foreign corporation in order to interpose an additional non-U.S. entity between themselves and U.S. tax administration. To the extent, however, that a foreign individual would have effectively connected income if the individual invested in a fund directly rather than through an offshore corporation, the foreign corporation itself has effectively connected income. Investment in a fund through an offshore corporation therefore generally does not reduce the aggregate U.S. tax liability of foreign individual investors.

Generally, an entity principally engaged in active trading in securities through agents in the United States would be considered as engaged in a trade or business in the United States. However, under rules referred to as the “securities trading safe harbor,” an exception is provided for a range of securities and commodities activities conducted in the United States by or on behalf of foreign persons.<sup>35</sup> Investment funds that are organized in offshore jurisdictions may satisfy the securities trading safe harbor and thereby may not be treated as engaged in a U.S. trade or business even if the funds’ investment or securities trading activities are managed by individuals working in the United States. As a result, a foreign partner investing in an offshore fund organized as a partnership may not be treated as engaged in a U.S. trade or business solely by reason of that investment, and may not be subject to U.S. net income tax on income from the investment.

A U.S. taxable investor generally obtains no tax advantage from investing in an offshore investment fund rather than a domestic one. If the fund is organized as foreign partnership, the U.S. investor is taxed on its distributive share of partnership income, just as if the fund were a U.S. partnership. If the fund is organized as a foreign corporation, or if the U.S. investor invests through a foreign “feeder” corporation, the passive foreign investment company or subpart F rules may cause the U.S. investor to lose the benefit of deferral of U.S. taxation of that investor’s share of the fund’s income.<sup>36</sup> Thus, neither a foreign investor nor a U.S. taxable investor would generally reduce U.S. net income tax liability by investing through an offshore investment fund, when compared to the U.S. tax liability that would be imposed were the investor to conduct the same activities directly. However, tax-exempt investors can reduce U.S. net income tax liability for unrelated business income tax by investing in an offshore investment fund organized as a corporation, or in offshore “feeder” corporation that is a partner in an offshore investment partnership.

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<sup>35</sup> Sec. 864(b). Special rules apply to foreign dealers. The securities trading safe harbor eliminates the need for the Internal Revenue Service to administer rules distinguishing between passive investment and active trading in this context. The securities trading safe harbor is believed to encourage foreign capital inflows to the United States, or is thought not to discourage them. The safe harbor is also thought to permit U.S. asset managers to compete with foreign asset managers in managing the investment assets of non-U.S. investors.

<sup>36</sup> The passive foreign investment company and subpart F rules are described in the section of this document entitled Present Law - International Taxation.

### Tax-exempt investors and unrelated business income tax

One reason for investing in alternative investment funds through a foreign corporation relates to the imposition of unrelated business income tax (“UBIT”) on tax-exempt organizations under present law. If a tax-exempt organization were to invest directly in the strategies followed by many alternative investment funds, it is likely that the tax-exempt organization’s income from that investment would be subject to UBIT, because, for example, the assets are active business assets that are unrelated to the organization’s exempt purpose, or the assets are debt-financed.

If tax-exempt organizations hold such investments through a partnership, a lookthrough rule applies, potentially subjecting the tax-exempt investors’ returns to UBIT. By contrast, if tax-exempt organizations hold potentially UBIT-producing partnership investments through a corporation, the corporation’s separate existence generally is respected for Federal tax purposes so that the lookthrough rule does not apply, and dividends paid by the corporation to the tax-exempt investors generally are excluded from the investors’ unrelated business taxable income. Tax-exempt organizations thus may have an incentive to invest in alternative investment funds through these “UBIT blockers” or “blocker corporations.” Such corporations often are established offshore in low-tax or zero-tax jurisdictions to avoid corporate tax at the blocker corporation level; in turn, the blocker corporation relies on the securities trading safe harbor described earlier to avoid U.S. net income tax on its securities investment/trading strategies.

### Deferral of income of managers

A U.S. based manager of an offshore investment fund can agree by contract to take performance-based returns to which the manager may be entitled either in the form of a carried interest, or in the form of contingent compensation. In the latter case, the manager can also negotiate to defer receipt of that income (and likewise to defer the concomitant tax liability) for a period of years.

The typical structure of an offshore hedge fund, in which the underlying fund is organized as a partnership, taxable U.S. investors invest through a “feeder” domestic partnership, and tax-exempt U.S. investors and foreign investors invest through a “feeder” foreign corporation, permits fund managers to optimize their after-tax performance-based returns. Fund managers do so by arranging to take those returns as carried interest where the underlying investment fund is expected to generate long-term capital gain (or where an alternative form might disadvantage taxable U.S. investors), and to take those returns in the form of contingent compensation (which compensation in turn often is subject to a voluntary agreement to defer receipt of the income) when the underlying investment fund generates short-term capital gain or ordinary income (and when doing so does not otherwise disadvantage investors). In a typical structure, managers can combine both approaches, by arranging to take performance-based income, not from the underlying investment fund, but rather from the domestic “feeder” fund, in the form of a carried interest in the domestic “feeder” partnership, and a contingent deferred compensation arrangement with the offshore “feeder” corporation.

In the case of an investor who is subject to U.S. tax, structuring the fund manager’s performance based returns as deferred compensation is not desirable as a tax planning matter because the payor’s deduction is postponed under U.S. tax law until the amount is included in

income by the fund manager. In the case of a U.S. taxpayer, this deferral of the deduction creates a tension which, in theory, may limit the amount of compensation that is deferred. This tension is not present with respect to the relationship between fund managers and offshore “feeder” corporations, because the ultimate investors in these corporations are tax exempt or otherwise not subject to U.S. tax and are indifferent as to the timing of a tax deduction for compensation.

If the carried interest is structured as nonqualified deferred compensation, all amounts received by the fund manager pursuant to the carried interest are taxable as ordinary income. In contrast, if the carried interest is structured as a partnership profits interest in the fund, the fund manager’s distributive share of the fund’s income and loss items retains the character that those items had at the fund level under present law. Thus, to the extent the fund’s income constitutes long-term capital gain or qualifying dividends eligible for the preferential capital gain tax rate, the consensus understanding of current law is that the fund manager’s share of that income is eligible for the preferential capital gain tax rate. However, in the case of funds (such as hedge funds) whose investment strategy involves relatively rapid turnover of assets, income generated by the fund is generally not eligible for the long-term capital gain tax rate, but rather, is generally subject to income tax at the same rate as ordinary compensation income.<sup>37</sup> In this situation, where preferential long-term capital gains tax rates are not available, the tax benefit of deferred compensation to the recipient may be substantial.

#### Quantifying the tax benefit of deferral of compensation

The principal advantage of deferral is the ability to retain earnings in the foreign corporation and invest them such that they are not subject to tax on an annual basis, i.e., invest them on a pre-tax basis. Suppose that a taxpayer in the 35 percent bracket earns \$100 of compensation today and defers it for five years, such that the foreign corporation can invest the money and earn a 10 percent return per year. The taxpayer would then have \$161.05 and pay tax of \$56.37, for an after-tax income of \$104.68. Suppose there is another taxpayer who cannot defer compensation, but has access to the same investment opportunity. This taxpayer receives \$100 in compensation today, pays tax of \$35, and has only \$65 to invest. The taxpayer invests that amount at an after-tax rate of 6.5 percent, i.e. a 10 percent pretax rate less 35 percent tax on the earnings each year. At the end of five years, the taxpayer will only have \$89.06. The \$15.62 ultimate difference in economic wealth between the taxpayer who could defer the compensation income for five years (whose deferred income in turn compounded at 10 percent per year), compared to the otherwise identically-situated taxpayer who was required to pay tax on the compensation income immediately (whose after-tax income compounded at 6.5 percent per year), can be analyzed as follows.

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<sup>37</sup> Situations exist in which hedge funds are subject to ordinary income rates (e.g., if the fund makes a mark-to-market election under section 475(f)). In general, compensation income is subject to employment tax (2.9 percent for amounts over \$97,500 for 2007), however, while short-term capital gain is not. See the Present Law section of *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. This document is available on the internet at [www.house.gov/jct](http://www.house.gov/jct).

In the deferral case, the employee can be understood at a conceptual level (by virtue of her agreement with her employer under which her deferred compensation grows at 10 percent per year) as if she also received \$100 in cash compensation (but in her case not taxable income) immediately, and then set aside \$35 of that \$100 to fund her entire tax liability (which \$35 in turn also was invested at 10 percent). Of course the employee did not actually receive cash upfront, but the effect of her agreement with her employer was to put her in the same economic position as if she did receive that cash and immediately invested it at a 10 percent rate. Each year the \$100 (and therefore the employee's ultimate tax bill) would notionally grow at 10 percent, but so would the \$35 component of that amount set aside to fund the employee's future tax bill. As a result, the \$35 notionally set aside by the employee in the first period would be sufficient to pay her taxes at the end of the fifth year. This means that the employee's total after-tax wealth at the end of the fifth year would equal \$65 (the portion of the \$100 notionally received at the start that was not needed to fund her tax liability) compounded at the full pretax rate of 10 percent, or \$104.68.

In other words, the incremental value of deferring income in this example is equivalent to the difference between investing \$65—the after-tax value of the compensation—at the pre-tax interest rate (10 percent), rather than the after-tax rate (6.5 percent), for the five-year life of the deferral. More generally, any deferral of income can be analyzed in the same way: the value of deferral is equivalent to the value of investing the after-tax amount of the income over the period of the deferral at the pre-tax rate of return.<sup>38</sup> It is as if the taxpayer who can defer her income must pay tax currently on the deferred amount, but then can invest the after-tax proceeds on a tax-exempt basis.<sup>39</sup>

The above example assumed that the employee could earn the normal pre-tax return on her deferred compensation. When the employer is a U.S. taxpayer, that assumption is not necessarily accurate, because the employer itself will be subject to tax on the returns that it earns on the cash attributable to the deferred compensation during the deferral period. This result follows from the fact that U.S. employers in general may not deduct expenses attributable to deferred compensation until that compensation is paid. In theory, therefore, if the employee and the U.S. employer are taxed at the same rate (e.g., 35 percent), and if the employer is not willing to subsidize the employee's deferred compensation (by effectively giving the employee additional compensation), the employer should not be willing to pay more than its after-tax rate

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<sup>38</sup> The proposition assumes that tax rates remain constant.

<sup>39</sup> This principle can also be understood as a special case of the well-known "Cary Brown theorem," which holds that, assuming constant tax rates, permitting an immediate deduction for the cost of a marginal asset that ordinarily would be purchased with after-tax dollars is equivalent to exempting the yield from the asset from tax. Cary Brown, "Business-Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen* 300 (1948). In the income deferral case, the analog of the purchase price of an asset is the taxpayer's after-tax income, because in the base case assets are purchased with after-tax dollars. The value of income deferral then becomes the tax exemption of the yield from that after-tax income amount for the life of the deferral.

of return (6.5 percent, in the above example) to the employee in respect of deferred compensation amounts.<sup>40</sup>

If these facts were universally the case, there would be no tax disadvantage to the U.S. tax administration system in deferred compensation arrangements. In practice, however, these facts often are not the case: an employer might, for example, be in a lower tax bracket than an employee (for example, by virtue of operating losses or the tax rates then in effect).<sup>41</sup> Notwithstanding these (and other) exceptions, the general presumption appears to be that there exists sufficient tension in the tax positions of employees and employers as to serve at least as a partial constraint on compensation deferral arrangements.

This tension in tax positions disappears entirely when the employer is an offshore corporation owned by foreign investors, and U.S. tax-exempt institutions. In that case, the employer never obtains a tax benefit from paying compensation or a tax detriment from deferring the payment of that compensation, because it is not a taxpayer at all. As a result, there is no incremental cost to the employer (or its owners) in permitting an employee to defer compensation, and the employer therefore in theory should be willing to pay to the employee up to the pre-tax return on the cash attributable to the deferred compensation. This result can be extended beyond simple time value of money type returns. For example, the deferred compensation may be treated by contract as if it were invested in the underlying investment fund, and the fund manager's synthetic investment therein would then compound as if it were a tax-exempt investment.

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<sup>40</sup> Halperin, "Interest in Disguise: Taxing the 'Time Value of Money'" 95 *Yale Law J.* 506 (1986). For this reason, a corporation may prefer to provide a rate of return on nonqualified deferred compensation that is equal to the increase in the value of its stock for the deferral period.

<sup>41</sup> *Id.*

## II. PRESENT LAW

### A. Federal Income Tax Treatment of Insurance Companies

#### In general

Present law provides special rules for determining the taxable income of insurance companies (subchapter L of the Code). Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. Insurance companies are subject to tax at regular corporate income tax rates.

#### Life insurance companies

##### In general

Under the law in effect from 1959 through 1983, a life insurance company was subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system, a company was taxed on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeded its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations was deferred, and was accounted for as part of a policyholder's surplus account and, subject to certain limitations, taxed only when distributed to stockholders or upon corporate dissolution (Phase III). To determine whether amounts had been distributed, a company maintained a shareholders surplus account, which generally included the company's previously taxed income that would be available for distribution to shareholders. In the Deficit Reduction Act of 1984, the three-phase tax structure was eliminated and the statutory scheme for taxation of life insurance companies was redesigned.

Present law provides rules for taxation of the life insurance company taxable income (LICTI) of a life insurance company. For Federal income tax purposes, a life insurance company means an insurance company that is engaged in the business of issuing life insurance and annuity contracts, or noncancellable health and accident insurance contracts, and that meets a 50-percent test with respect to its reserves (sec. 816(a)). This statutory provision applicable to life insurance companies defines the term "insurance company" to mean any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies (sec. 816(a)).

LICTI is life insurance gross income reduced by life insurance deductions (sec. 801). An alternative tax applies if a company has a net capital gain for the taxable year, if such tax is less than the tax that would otherwise apply. Life insurance gross income is the sum of (1) premiums, (2) decreases in certain reserves, and (3) other amounts generally includible by a taxpayer in gross income. Life insurance deductions means the general deductions provided in section 805, and the small life insurance company deduction under section 806 (which functions as a reduction in the tax on LICIT equal to 60 percent of tentative LICIT up to \$3 million, phasing out for companies with tentative LICIT between \$3 and \$15 million, provided that assets of the company do not exceed \$500 million).

### Deduction for increases in reserves

A life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves (sec. 807). Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules. Special rules are provided, eliminating unrealized gains and losses from reserve increases and decreases, in the case of reserves based on separate accounts with respect to variable contracts (sec. 817).

### Proration of deductions relating to untaxed income

Because deductible reserves might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by a portion<sup>42</sup> of tax-exempt interest (sec. 807(b)(2)(B) and (b)(1)(B)). Similarly, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends (secs. 805(a)(4), 812). Fully deductible dividends from affiliates are excluded from the application of this proration formula (so long as such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be fully deductible if received directly by the taxpayer). In addition, the proration rule includes in prorated amounts the increase for the taxable year in policy cash values of life insurance policies and annuity and endowment contracts owned by the company (the inside buildup on which is not taxed).

## **Property and casualty insurance companies**

### In general

Under the law prior to 1986, a variety of special rates, deductions, and exemptions applied to mutual property and casualty insurance companies, distinguishing their Federal income tax treatment from stock property and casualty companies. The Tax Reform Act of 1986 repealed the special rates, deductions, and most of the exemptions,<sup>43</sup> and consolidated and modified the tax rules applicable to property and casualty companies.

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<sup>42</sup> The portion is referred to in the statute as the "policyholders' share" of tax-exempt interest; this term originates with the notion that a share of the assets of the company can be considered as belonging to the policyholders. The policyholders' share is the excess of 100 percent over the portion determined as the "company's share" under section 812. In general, the company's share is that percentage that reflects the investment income of the company for the taxable year, reduced by policyholder dividends, policy interest credited to policyholders, and a portion of investment expenses.

<sup>43</sup> A property and casualty insurance company is eligible to be exempt from Federal income tax if (1) its gross receipts for the taxable year do not exceed \$600,000, and (2) the premiums received for the taxable year are greater than 50 percent of its gross receipts (sec. 501(c)(15)). This rule also applies in the case of certain mutual companies with gross receipts not exceeding \$150,000 for the taxable year and meeting other requirements. A company that does not meet the definition of an insurance company (sec. 816(a)) is not eligible to be exempt from Federal income tax under this rule. A company whose

Under present law, the taxable income of a property and casualty insurance company is determined as the sum of its gross income from underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions (sec. 832). For purposes of determining the company's gross income, underwriting income and investment income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners (sec. 832(b)(1)(A)).

#### Deduction for unpaid loss reserves

Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred (sec. 832(b)(3)). Losses incurred include certain unpaid losses (reported losses that have not been paid, estimates of losses incurred but not reported, resisted claims, unpaid loss adjustment expenses). Present law provides for the discounting of the deduction for loss reserves to take account partially of the time value of money (sec. 846). Thus, present law limits the deduction for unpaid losses to the amount of discounted unpaid losses. Any net decrease in the amount of unpaid losses results in income inclusion, and the amount included is computed on a discounted basis.

The discounted reserves for unpaid losses are calculated using a prescribed interest rate which is based on the applicable Federal mid-term rate ("mid-term AFR"). The discount rate is the average of the mid-term AFRs effective at the beginning of each month over the 60-month period preceding the calendar year for which the determination is made.

To determine the period over which the reserves are discounted, a prescribed loss payment pattern applies. The prescribed length of time is either the accident year and the following three calendar years, or the accident year and the following 10 calendar years, depending on the line of business. In the case of certain "long-tail" lines of business, the 10-year period is extended, but not by more than 5 additional years. Thus, present law limits the maximum duration of any loss payment pattern to the accident year and the following 15 years. The Treasury Department is directed to determine a loss payment pattern for each line of business by reference to the historical loss payment pattern for that line of business using aggregate experience reported on the annual statements of insurance companies, and is required to make this determination every five years, starting with 1987.

Under the discounting rules, an election is provided permitting a taxpayer to use its own (rather than an industry-wide) historical loss payment pattern with respect to all lines of business, provided that applicable requirements are met.

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investment activities outweigh its insurance activities is not considered to be an insurance company for this purpose. Present law further provides that a property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) do not exceed \$1.2 million (sec. 831(b)). For purposes of determining any of these amounts, amounts received by all members of a controlled group of corporations of which the company is a part are taken into account.

### Reinsurance premiums deductible

In determining premiums earned for the taxable year, a property and casualty company deducts from gross premiums written on insurance contracts during the taxable year the amount of premiums paid for reinsurance (sec. 832(b)(4)(A)).

### Unearned premiums

Further, the company deducts from gross premiums the increase in unearned premiums for the year (sec. 832(b)(4)(B)). The company is required to reduce the deduction for increases in unearned premiums by 20 percent. This amount serves to represent the allocable portion of expenses incurred in generating the unearned premiums, so as to provide a degree of matching of the timing of inclusion of income and deduction of associated expenses.

### Proration of deductions relating to untaxed income

In calculating its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment or annuity contracts the company owns (sec. 832(b)(5)). This rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from wholly or partially deductible dividends, or from other untaxed amounts.

### **Treatment of reinsurance**

Present law includes a rule enacted in 1984 providing authority to the Treasury Department to reallocate items and make adjustments in reinsurance transactions to prevent tax avoidance or evasion (sec. 845).<sup>44</sup>

The rule generally permits the Treasury Department to make reallocations in related party reinsurance transactions and in reinsurance transactions between unrelated parties. The legislative history of the provision states that "the operative standards for both of the reinsurance adjustment provisions are objective tests of (1) whether adjustments are necessary to more properly reflect income or (2) whether the transaction has a significant tax avoidance effect."<sup>45</sup> The legislative history further provides that in determining whether a reinsurance agreement between unrelated parties has a significant tax avoidance effect with respect to one or both of the parties, appropriate factors for the Treasury Department to take into account are (1) the duration or age of the business reinsured, which bears on the issue of whether significant economic risk is transferred between the parties, (2) the character of the business (as long-term or not), (3) the structure for determining potential profits, (4) the duration of the reinsurance agreement, (5) the

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<sup>44</sup> Conference Report to H.R. 4170, The Deficit Reduction Act of 1984, H. Rep. No. 98-861 (June 23, 1984), 1060.

<sup>45</sup> *Id.* at 1062.

parties rights to terminate and the consequences of termination, such as the existence of a payback provision; (6) the relative tax positions of the parties, and (7) the financial situations of the parties.<sup>46</sup>

The provision was amended in 2004 to provide the Treasury Department with authority to allocate among the parties to a reinsurance agreement or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment in order to reflect the proper source, character, or amount of the item.<sup>47</sup> In expanding this authority to the amount (not just the source and character) of any such item, Congress expressed the concern that “reinsurance transactions were being used to allocate income, deductions, or other items inappropriately among U.S. and foreign related persons,” and that “foreign related party reinsurance arrangements may be a technique for eroding the U.S. tax base.”<sup>48</sup>

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<sup>46</sup> *Id.* at 1063-4. In *Trans City Life Insurance Company v. Comm'r*, 106 T.C. 274 (1996), non-acq., 1997-2 C.B. 1, Nov. 3, 1997, the Tax Court held that two reinsurance agreements did not have significant tax avoidance effects, based on the application of these factors.

<sup>47</sup> Section 803 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

<sup>48</sup> See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, JCS-5-05, May 2005, 351.

## **B. Reinsurance Excise Tax**

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks (secs. 4371-4374). Under this rule, a gross-basis excise tax is imposed at the rate of 1 percent on reinsurance and life insurance premiums. The excise tax is imposed at the rate of 4 percent on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or if an applicable income tax treaty provides an exemption from the tax.<sup>49</sup> The excise tax does not provide a credit with respect to the excise tax paid by one party if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

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<sup>49</sup> U.S. tax treaties that provide a waiver or exemption of the insurance excise tax generally include an anti-conduit rule to prevent third-country residents from taking advantage of the treaty exemption. See the section of this document entitled Present Law - International Taxation - exemption from the insurance premiums excise tax.

## C. International Taxation

### **General U.S. tax rules applicable to business operations**

The United States employs a worldwide tax system under which U.S. persons (including U.S. citizens, U.S. resident individuals, and domestic corporations) generally are taxed on all income, whether derived in the United States or abroad. In contrast, foreign persons (including nonresident alien individuals and foreign corporations) are taxed in the United States only on income that has a sufficient nexus to the United States.

Foreign persons are subject to U.S. tax on income that is effectively connected with the conduct of a trade or business in the United States. Such income may be derived from U.S. or foreign sources. This income generally is taxed in the same manner and at the same rates as income of a U.S. person. In addition, foreign persons generally are subject to U.S. tax at a 30-percent rate on certain gross income (such as interest, dividends, rents, royalties, and premiums) derived from U.S. sources.

An income tax treaty between the United States and a foreign country may reduce or eliminate the 30-percent gross-basis withholding tax on certain payments. A tax treaty also may permit the United States to tax a foreign person's income from business operations only to the extent the income is attributable to that person's permanent establishment in the United States. Finally, a tax treaty may eliminate the insurance premiums excise tax described above.

### **U.S. persons—income from a foreign business**

#### Section 367

If a U.S. corporation reincorporates in a foreign jurisdiction, seeking to replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation, several provisions of the tax law apply to the transaction. In certain outbound stock transactions, the U.S. shareholders generally recognize gain (but not loss) under section 367(a), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation's share value has declined, and/or it has many foreign or tax-exempt shareholders, the impact of this section 367(a) "toll charge" is reduced. The transfer of foreign subsidiaries or other assets to the foreign parent corporation also may give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions under secs. 1001, 311(b), 304, 367, 1248 or other provisions). The tax on any income recognized as a result of these restructurings may be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

In asset inversions, the U.S. corporation generally recognizes gain (but not loss) under section 367(a) as though it had sold all of its assets, but the shareholders generally do not recognize gain or loss, assuming the transaction meets the requirements of a reorganization under section 368.

## Inversions

Rules limiting the tax benefits of certain corporate and partnership inversion transactions were added to the Code in 2004.<sup>50</sup> Present law defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. Certain partnership transactions also are covered.

The first type of inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the “expanded affiliated group”), does not have substantial business activities in the entity’s country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.

In determining whether a transaction meets the definition of an inversion under the provision, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called “hook” stock), that stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, all stock of the new foreign corporation would be disregarded, with the result that the transaction would not meet the definition of an inversion under the provision. Stock sold in a public offering related to the transaction also is disregarded for these purposes.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the provision are disregarded. In addition, the Treasury Secretary is to provide regulations to carry out the provision, including regulations to prevent the avoidance of the purposes of the provision, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the Treasury Secretary is granted authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the provision.

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if at least a 60-percent ownership threshold is met, then a second set of rules

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<sup>50</sup> Section 7874 was enacted in section 801 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level “toll charges” for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.

Inversion transactions include certain partnership transactions. Specifically, the provision applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified “toll charge” proposals apply at the partner level.

A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

#### Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.<sup>51</sup> Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment

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<sup>51</sup> Sec. 1297. There are certain exceptions to “passive income,” including any income derived in the active conduct of an insurance business by a corporation this is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation. Sec. 1297(b)(2)(B). Section 1297(c) provides a look-through rule to be used in determining whether a foreign corporation is a passive foreign investment company, if that corporation owns at least 25 percent by value of the stock of another corporation. When the look-through rule applies, the first corporation is treated as owning directly its proportionate share of the assets of the other corporation and as receiving directly its share of the income of the other corporation. Consequently, in such a case, ownership of 25 percent or more of an active business entity can cause a foreign corporation not to be treated as a passive foreign investment company.

companies that are “qualified electing funds,” under which electing U.S. shareholders currently include in gross income their respective shares of the company’s earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.<sup>52</sup> A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.<sup>53</sup> A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as “marking to market.”<sup>54</sup>

### Subpart F

Under the subpart F rules, 10-percent U.S. shareholders of a controlled foreign corporation (“CFC”) are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income. Foreign base company income includes, among other things, foreign personal holding company income and foreign base company services income (i.e., income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC’s country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC’s country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity

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<sup>52</sup> Secs. 1293-1295.

<sup>53</sup> Sec. 1291. This interest charge is imposed when a shareholder receives an excess distribution, which in general is a distribution in excess of 125 percent of the average amount received during the three preceding taxable years.

<sup>54</sup> Sec. 1296.

contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income.

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").

In the case of insurance, in addition to a temporary exception from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, certain temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

In the case of a life insurance or annuity contract, reserves for such contracts are determined as follows for purposes of these provisions. The reserves equal the greater of: (1) the net surrender value of the contract (as defined in section 807(e)(1)(A)), including in the case of pension plan contracts; or (2) the amount determined by applying the tax reserve method that would apply if the qualifying life insurance company were subject to tax under Subchapter L of the Code, with the following modifications. First, there is substituted for the applicable Federal interest rate an interest rate determined for the functional currency of the qualifying insurance company's home country, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable Federal interest rate (within the meaning of section 1274(d)). Second, there is substituted for the prevailing State assumed rate the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Third, in lieu of U.S. mortality and morbidity tables, mortality and morbidity tables are applied that reasonably reflect the current mortality and morbidity risks in the foreign country. Fourth, the Treasury Secretary may provide that the interest rate and mortality and morbidity tables of a qualifying insurance company may be used for one or more of its branches when appropriate. In no event may the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe, equalization, or deficiency reserve or any similar reserve.

Present law permits a taxpayer in certain circumstances, subject to approval by the Internal Revenue Service ("IRS") through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes. In seeking a ruling, the taxpayer is required to provide the IRS with

necessary and appropriate information as to the method, interest rate, mortality and morbidity assumptions and other assumptions under the foreign reserve rules so that a comparison can be made to the reserve amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under Subchapter L of the Code (with the modifications provided under present law for purposes of these exceptions). The IRS also may issue published guidance indicating its approval. Present law continues to apply with respect to reserves for any life insurance or annuity contract for which the IRS has not approved the use of the foreign statement reserve. An IRS ruling request under this provision is subject to the present-law provisions relating to IRS user fees.

### **Foreign persons—income from a U.S. business**

The United States taxes on a net basis a foreign person's income that is effectively connected with the conduct of a trade or business in the United States.<sup>55</sup> Any gross income derived by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person's income from the business.<sup>56</sup>

#### U.S. trade or business

##### In general

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged.<sup>57</sup>

The question whether a foreign person is engaged in a U.S. trade or business has generated a significant body of case law. Basic issues involved in the determination include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States with respect to the business is sufficient to attribute those functions to the foreign person.

The Code includes specific rules for determining whether certain activities constitute a trade or business. The term "trade or business within the United States" expressly includes the performance of personal services within the United States.<sup>58</sup> An exception is provided in the case of a nonresident alien individual's performance of services for a foreign employer, where

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<sup>55</sup> Secs. 871(b), 882.

<sup>56</sup> Secs. 871(b)(2), 882(a)(2).

<sup>57</sup> Secs. 875.

<sup>58</sup> Sec. 864(b).

both the total compensation received for the services during the year and the period in which the individual is present in the United States are de minimis.<sup>59</sup>

### Securities trading safe harbor

Detailed rules govern whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.<sup>60</sup> Under these rules (colloquially referred to as trading safe harbors), trading in stock or securities or commodities by a foreign person through an independent agent such as a resident broker generally is not treated as the conduct of a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which the trading is effected. Trading in stock or securities or commodities for the foreign person's own account, whether by the foreign person or the foreign person's employees or through a resident broker or other agent (even if that agent has discretionary authority to make decisions in effecting the trading) also generally is not treated as the conduct of a U.S. business provided that the foreign person is not a dealer in stock or securities or commodities.

### Effectively connected income

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on the income that is "effectively connected" with such business. Specific statutory rules govern the determination of whether income is so effectively connected.

In the case of U.S.-source capital gain or loss and U.S.-source income of a type that would be subject to gross basis U.S. taxation, the factors taken into account in determining whether the income, gain, deduction, or loss is effectively connected with a U.S. trade or business include whether the amount is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the amount.<sup>61</sup> In the case of any other U.S.-source income, gain, deduction, or loss, such amounts are all treated as effectively connected with the conduct of the trade or business in the United States.<sup>62</sup>

Foreign-source income of a foreign person that is effectively connected with the conduct of a trade or business in the United States may also be taxed by the United States, subject to a credit for any foreign income taxes.<sup>63</sup> However, foreign-source income, gain, deduction, or loss generally is considered to be effectively connected with a U.S. business only if the person has an

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<sup>59</sup> Sec. 864(b)(1).

<sup>60</sup> Sec. 864(b)(2).

<sup>61</sup> Sec. 864(c)(2).

<sup>62</sup> Sec. 864(c)(3).

<sup>63</sup> Secs. 864(c)(4), 906.

office or other fixed place of business within the United States to which such income, gain, deduction, or loss is attributable and such income is of a certain type (i.e., certain rents or royalties for the use of intangible property, certain interest or dividends derived in the active conduct of a banking or financing business, or certain income from sales of inventory or other property held primarily for sale in the ordinary course of a trade or business).<sup>64</sup> Foreign-source income of a type not specified above generally is exempt from U.S. tax.<sup>65</sup>

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if either the agent has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or the agent has a stock of merchandise from which he regularly fills orders on behalf of the foreign person.<sup>66</sup> Assuming that an office or other fixed place of business does exist, income, gain, deduction, or loss is not considered attributable to such office unless the office was a material factor in the production of the income, gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss was derived.<sup>67</sup>

#### Source of income

The Code provides rules for the determination of the source of income. For example, interest and dividends paid by U.S. persons generally are considered U.S.-source income.<sup>68</sup> Conversely, interest and dividends paid by foreign persons generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. persons with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign persons with U.S. businesses.<sup>69</sup> Rents and royalties paid for the use of property in the United States generally are considered U.S.-source income.<sup>70</sup> Subject to significant exceptions, the source of income from the sale of personal property depends on the residence of the seller (e.g., if the seller is foreign, the gain is foreign source).<sup>71</sup> Underwriting income from issuing insurance or annuity contracts generally is

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<sup>64</sup> Sec. 864(c)(4)(B).

<sup>65</sup> Sec. 864(c)(4)(A).

<sup>66</sup> Sec. 864(c)(5)(A).

<sup>67</sup> Sec. 864(c)(5)(B).

<sup>68</sup> Sec. 861(a)(1), (2).

<sup>69</sup> Sec. 861(c).

<sup>70</sup> Sec. 861(a)(4).

<sup>71</sup> Sec. 865(a).

treated as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States.<sup>72</sup>

### Insurance companies

Special rules apply to a foreign corporation carrying on an insurance business in the United States that would qualify as an insurance company (based on its effectively connected income) if it were a domestic corporation.<sup>73</sup> Under those rules, the foreign corporation generally is taxed on that effectively connected income in the same manner as a U.S. insurance company. Any other income of the foreign corporation is taxed under the gross-basis taxation rules described below.

Special rules apply for purposes of determining the effectively-connected income of an insurance company. The foreign-source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code is treated as effectively connected, provided that such income is attributable to its U.S. business.<sup>74</sup>

### Withholding tax

In the case of U.S.-source interest, dividends, rents, royalties, premiums, or other similar types of income (known as fixed or determinable, annual or periodical gains, profits and income), the United States generally imposes a flat 30-percent tax on the gross amount paid to a foreign person if such income or gain is not effectively connected with the conduct of a U.S. trade or business.<sup>75</sup> This tax does not apply to insurance premiums paid with respect to a contract that is subject to the insurance premiums excise tax described above.<sup>76</sup> The 30-percent gross-basis tax generally is collected by means of withholding by the person making the payment to the foreign person receiving the income.<sup>77</sup> Accordingly, the tax generally is referred to as a withholding tax. In most instances, the amount withheld by the U.S. payor is the final tax liability of the foreign recipient and, thus, the foreign recipient files no U.S. tax return with respect to this income.

The United States generally does not tax capital gains of a foreign corporation that are not connected with a U.S. trade or business. Capital gains of a nonresident alien individual that are not connected with a U.S. business generally are subject to the 30-percent withholding tax

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<sup>72</sup> Sec. 861(a)(7).

<sup>73</sup> Sec. 842.

<sup>74</sup> Sec. 864(c)(4)(C).

<sup>75</sup> Secs. 871(a), 881.

<sup>76</sup> Treas. Reg. sec. 1.1441-2(a)(7).

<sup>77</sup> Secs. 1441, 1442.

only if the individual was present in the United States for 183 days or more during the year.<sup>78</sup> Also subject to tax at a flat rate of 30 percent are any foreign person's gains from the sale or exchange of patents, copyrights, trademarks, and other like property, or of any interest in such property, to the extent the gains are from payments that are contingent on the productivity, use, or disposition of the property or interest sold or exchanged.<sup>79</sup>

Gains of a foreign person on the disposition of U.S. real property interests are taxed on a net basis under the Foreign Investment in Real Property Tax Act, even if they are not otherwise effectively connected with a U.S. trade or business.<sup>80</sup> Similarly, rental and other income from U.S. real property may be taxed, at the election of the taxpayer, on a net basis at graduated rates.<sup>81</sup>

Although payments of U.S.-source interest that is not effectively connected with a U.S. trade or business generally are subject to the 30-percent withholding tax, there are significant exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax.<sup>82</sup> Original issue discount on obligations maturing in six months or less is also exempt from tax.<sup>83</sup> An additional exception is provided for certain interest paid on portfolio obligations.<sup>84</sup> Portfolio interest generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (1) on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) that is not received by a 10-percent shareholder.<sup>85</sup> This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person.<sup>86</sup> Moreover, this exception is not available for certain contingent interest payments.<sup>87</sup>

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<sup>78</sup> Sec. 871(a)(2).

<sup>79</sup> Secs. 871(a)(1)(D), 881(a)(4).

<sup>80</sup> Secs. 897, 1445, 6039C, 6652(f).

<sup>81</sup> Secs. 871(d), 882(d).

<sup>82</sup> Secs. 871(i)(2)(A), 881(d).

<sup>83</sup> Sec. 871(g)(1)(B)(i).

<sup>84</sup> Secs. 871(h), 881(c).

<sup>85</sup> Sec. 871(h).

<sup>86</sup> Sec. 881(c)(3).

<sup>87</sup> Sec. 871(h)(4).

## Earnings stripping

A foreign parent corporation with a U.S. subsidiary may seek to reduce the U.S. subsidiary's U.S. tax liability by having the U.S. subsidiary pay deductible amounts such as interest, rents, royalties, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments. Although the United States generally subjects foreign corporations to a 30-percent withholding tax on the receipt of such payments, this tax may be reduced or eliminated under an applicable income tax treaty. Consequently, foreign-owned U.S. corporations may seek to use certain treaties to facilitate earnings stripping transactions without having their deductions offset by U.S. withholding taxes.<sup>88</sup>

Generally, the Code limits the ability of corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. A deduction for "disqualified interest" paid or accrued by a corporation in a taxable year is generally disallowed if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1 (the so-called "safe harbor"); and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion).<sup>89</sup> Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest; or (2) unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"). Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

Under a provision included in the Tax Increase Prevention and Reconciliation Act of 2005, except to the extent provided by regulations, the foregoing earnings stripping rules apply to a corporate partner of a partnership.<sup>90</sup> The corporation's share of partnership liabilities is treated as liabilities of the corporation for purposes of applying the earnings stripping rules to the corporation. The corporation's distributive shares of interest income and interest expense of the partnership are treated as interest income or interest expense of the corporation.

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<sup>88</sup> For example, it appears that the U.S.-Barbados income tax treaty was often used to facilitate earnings stripping arrangements. That treaty was amended in 2004 to make it less amenable to such use. It is possible, however, that other treaties in the U.S. network might be used for similar purposes. For a discussion of this issue, see Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Barbados* (JCX-55-04), September 16, 2004, at 12-20, 22.

<sup>89</sup> Sec. 163(j).

<sup>90</sup> Pub. L. No. 109-222, sec. 501 (2006).

### Branch level taxes

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As discussed above, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Similarly, as discussed above, interest payments made by a U.S. corporation to foreign creditors are subject to a U.S. withholding tax in certain circumstances. Pursuant to the branch tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest deducted by, the U.S. branch of the foreign corporation.<sup>91</sup> The branch level taxes are comparable to these second-level taxes. In addition, where a foreign corporation is not subject to the branch profits tax as the result of a treaty, it may be liable for withholding tax on actual dividends it pays to foreign shareholders.

### U.S. income tax treaties

The United States has entered into comprehensive income tax treaties with more than 50 countries, including a number of countries with well-developed insurance industries such as Barbados, Germany, Switzerland, and the United Kingdom. The United States has also entered into a tax treaty with Bermuda, another country with a significant insurance industry, which applies only with respect to the taxation of insurance enterprises.<sup>92</sup>

### Comprehensive tax treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the source country in treaties are premised on the assumption that the country of residence will tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to

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<sup>91</sup> Sec. 884.

<sup>92</sup> The U.S.-Bermuda treaty also includes a mutual assistance provision.

impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term resident so that an individual or corporation generally will not be subject to tax as a resident by both of the countries. Treaties generally provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other country will not be required to pay tax in that other country unless their contacts exceed certain specified minimums (e.g., presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that such income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on such income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner.

#### U.S.-Bermuda tax treaty

The U.S.-Bermuda treaty generally exempts from U.S. taxation the business profits of a Bermuda insurance enterprise from carrying on the business of insurance (including insubstantial amounts of income incidental to such business), unless the insurance enterprise carries on business in the United States through a U.S. permanent establishment. For the purposes of the treaty, an insurance enterprise is defined as an enterprise whose predominant business activity is the issuing of insurance or annuity contracts or acting as the reinsurer of risks underwritten by insurance companies, together with the investing or reinvesting of assets held in respect of insurance reserves, capital, and surplus incident to the carrying on of the insurance business.

#### Permanent establishment

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus to mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties apply, or whether those items of income will be taxed as business profits.

In general, under the United States Model Income Tax Convention of November 15, 2006 (the "U.S. model treaty") and many bilateral U.S. tax treaties, including the treaties with Barbados, Germany, Switzerland, and the United Kingdom, a permanent establishment is a fixed place of business in which the business of an enterprise is wholly or partly carried on.<sup>93</sup> A

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<sup>93</sup> The U.S. tax treaty with Bermuda uses a definition of permanent establishment consistent with the description that follows.

permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources.

The U.S. model treaty and many bilateral U.S. tax treaties provide that the following activities are deemed not to constitute a permanent establishment: (1) the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise; (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery or solely for processing by another enterprise; and (3) the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise. The U.S. model treaty and many bilateral U.S. tax treaties also provide that the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character does not constitute a permanent establishment. The U.S. model treaty and many bilateral U.S. tax treaties provide that a combination of these activities will not give rise to a permanent establishment, if the combination results in an overall activity that is of a preparatory or auxiliary character.

Under the U.S. model treaty and many bilateral U.S. tax treaties, if a person, other than an independent agent, is acting in a treaty country on behalf of an enterprise of the other country and has, and habitually exercises in such first country, the authority to conclude contracts in the name of such enterprise, the enterprise is deemed to have a permanent establishment in the first country in respect of any activities undertaken for that enterprise. This rule does not apply where the activities are limited to the preparatory and auxiliary activities described in the preceding paragraph.

No permanent establishment is deemed to arise, under the U.S. model treaty and many bilateral U.S. tax treaties, if the agent is a broker, general commission agent, or any other agent of independent status, provided that the agent is acting in the ordinary course of its business. Generally, whether an enterprise and an agent are independent is a factual determination, and the relevant factors in making this determination include: (1) the extent to which the agent operates on the basis of instructions from the principal; (2) the extent to which the agent bears business risk; and (3) whether the agent has an exclusive or nearly exclusive relationship with the principal.

The U.S. model treaty and many bilateral U.S. tax treaties provide that the fact that a company that is a resident of one country controls or is controlled by a company that is a resident of the other country or that carries on business in the other country does not in and of itself cause either company to be a permanent establishment of the other.

#### Exemption from the insurance premiums excise tax

Certain U.S. tax treaties, including the treaties with Germany, Switzerland, and the United Kingdom, apply to the insurance premiums excise tax of section 4371, in addition to the Federal income taxes imposed by the Code. Generally, when a foreign person qualifies for benefits under such a treaty, the United States is not permitted to collect the insurance premiums excise tax from that person. To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The anti-conduit rule provides that the treaty applies to the insurance premiums excise tax only to the

extent that the risks covered by the premiums are not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).

The U.S. tax treaties with Barbados and Bermuda also provide that they apply to the insurance premiums excise tax, although the Senate's ratification of the U.S.-Bermuda treaty was subject to a reservation with respect to the treaty's application to the insurance premiums excise tax. Moreover, section 6139 of the Technical and Miscellaneous Revenue Act of 1988 provides that neither the U.S.-Barbados nor the U.S.-Bermuda treaty will prevent imposition of the insurance premiums excise tax on premiums, regardless of when paid or accrued, allocable to insurance coverage for periods after December 31, 1989.<sup>94</sup> Accordingly, no exemption from the insurance premiums excise tax is available under those two treaties with respect to premiums allocable to insurance coverage beginning on or after January 1, 1990.

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<sup>94</sup> Pub. L. No. 100-647.

## **D. Present Law and Background of the Unrelated Business Income Tax and Debt-Financed Income**

### **Present law of the unrelated business income tax and debt-financed property rules**

#### Overview of the unrelated business income tax

The Code imposes a tax, at ordinary corporate rates, on the income that a tax-exempt organization obtains from an “unrelated trade or business ... regularly carried on by it.”<sup>95</sup> Most exempt organizations are subject to the tax.<sup>96</sup> Generally, “unrelated trade or business” is “any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose.”<sup>97</sup> The Code thus sets up a three-part test for determining whether income from an activity is subject to the unrelated business income tax: (1) the activity constitutes a trade or business; (2) the activity is regularly carried on; and (3) the activity is not substantially related to the organization’s tax-exempt purposes. An organization that is subject to the unrelated business income tax and that has \$1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Passive income, such as dividends, interest, royalties, certain rents, and certain gains and losses from the sale or exchange of property, is exempt from the unrelated business income tax.<sup>98</sup> In general, the exemption for such passive income applies unless the income is derived from debt-financed property<sup>99</sup> or is in the form of certain payments from certain 50-percent controlled subsidiaries.<sup>100</sup> Other exemptions from the unrelated business income tax are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special unrelated business income tax provisions exempt from tax certain activities of trade shows and State fairs, income from bingo games, and income from the distribution of certain low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

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<sup>95</sup> Secs. 512(a)(1), 511(a)(1).

<sup>96</sup> Organizations subject to the unrelated business income tax include all organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts), qualified pension, profit-sharing, and stock bonus plans described in section 401(a), and certain State colleges and universities. Sec. 511(a)(2).

<sup>97</sup> Sec. 513(a).

<sup>98</sup> Sec. 512(b)(1)-(3), (5).

<sup>99</sup> Sec. 512(b)(4).

<sup>100</sup> Sec. 512(b)(13).

## Overview of the debt-financed property rules

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Special rules apply in the case of an exempt organization that owns an interest in a partnership (or a pass-through entity taxed as a partnership) that holds debt-financed property.<sup>101</sup> In general, in such cases, if the partnership incurs acquisition indebtedness with respect to property that, if held directly by the exempt organization, would not qualify for an exception from the debt-financed property rules, the receipt of income by the exempt organization with respect to such property may result in recognition of unrelated debt-finance income.

Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property.<sup>102</sup> Acquisition indebtedness does not include, however, (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption, (2) obligations to pay certain types of annuities, (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons, or (4) indebtedness incurred by a qualified organization to acquire or improve real property (the "real property exception").<sup>103</sup>

### Exception for debt-financed real property investments by qualified organizations

For purposes of the real property exception, a qualified organization is: (1) an educational organization described in section 170(b)(1)(A)(ii)<sup>104</sup> and its affiliated supporting organizations; (2) a qualified trust described in section 401(a) (hereinafter "pension funds"); (3) a title holding company described in section 501(c)(25) (insofar as it holds shares of organizations described in (1) or (2)<sup>105</sup>); or (4) a retirement income account described in section 403(b)(9).<sup>106</sup> To qualify for the real property exception, an acquisition or improvement by the qualified organization must meet several requirements. These include: (1) a requirement generally that the price of the property is a fixed amount determined as of the date of the

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<sup>101</sup> Sec. 512(c).

<sup>102</sup> Sec. 514(c)(1).

<sup>103</sup> Sec. 514(c).

<sup>104</sup> This Code section generally describes an educational organization that operates as a school (i.e., "an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on").

<sup>105</sup> Sec. 514(c)(9)(C) & (F).

<sup>106</sup> Sec. 514(c)(9)(C).

acquisition or completion of the improvement; (2) restrictions against payment of the indebtedness of the arrangement being dependent upon the revenue, income, or profits derived from the property; (3) restrictions concerning sale-leaseback arrangements; and (4) in general, a prohibition against seller financing.<sup>107</sup>

Additional requirements must be met for the real property exception to apply where the real property is held by a partnership in which a qualified organization is a partner. To qualify for the real property exception, the partnership must meet all of the above-described general requirements and must meet one of the following three requirements: (1) all of the partners of the partnership are qualified organizations; (2) each allocation to a partner of the partnership which is a qualified organization is a qualified allocation (within the meaning of section 168(h)(6)); or (3) the partnership satisfies a rule prohibiting disproportionate allocations.<sup>108</sup>

The disproportionate allocation rule requires two things: first, that the organization satisfy what commonly is referred to as the “fractions rule,” and second, that each allocation with respect to the partnership have substantial economic effect within the meaning of section 704(b)(2).<sup>109</sup> Under the fractions rule, the allocation of items to any partner that is a qualified organization cannot result in such partner having a share of the overall partnership income for any taxable year greater than such partner’s share of overall partnership loss for the taxable year for which such partner’s loss share will be the smallest.<sup>110</sup> A partnership generally must satisfy the fractions rule on an actual basis and on a prospective basis for each taxable year of the partnership in which it holds debt-financed property and has at least one partner that is a qualified organization.<sup>111</sup> The fractions rule generally is intended to prevent the shifting of disproportionate income or gains to tax-exempt partners of the partnership or the shifting of disproportionate deductions, losses, or credits to taxable partners.

## **Legislative history of the unrelated business income tax and debt-financed property rules**

### Business and debt-financed income prior to 1950

Until the introduction of the unrelated business income tax in 1950, exempt organizations enjoyed a full exemption from Federal income tax. There was no statutory limitation on the amount of business activity an exempt organization could conduct so long as the earnings from the business were used for exempt purposes. In court decisions, tax-exemption was extended to organizations that did not conduct any charitable programs, but rather operated commercial businesses for the benefit of a charitable organization. Tax exemption for such so called

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<sup>107</sup> Sec. 514(c)(9)(B)(i)-(v).

<sup>108</sup> Sec. 514(c)(9)(B)(vi) & (E).

<sup>109</sup> Sec. 514(c)(9)(B)(E)(i).

<sup>110</sup> Sec. 514(c)(9)(B)(E)(i)(I).

<sup>111</sup> Treas. Reg. sec. 1.514(c)-2(b)(2)(i).

“feeder” organizations was recognized, for example in *Roche’s Beach, Inc. v. Commissioner*,<sup>112</sup> and *C.F. Mueller Co. v. Commissioner*.<sup>113</sup>

In addition to the use of feeder corporations as a source of revenue, another common practice of exempt organizations in the years before 1950 was the acquisition of real estate with borrowed funds. In a typical transaction, a tax-exempt organization would borrow the entire purchase price of real property, lease the property back to the seller under a long-term lease, and service the loan with tax-free rental income from the lease.<sup>114</sup>

### Revenue Act of 1950

As a response to these practices, in the Revenue Act of 1950 Congress subjected charitable organizations (not including churches), and certain other exempt organizations to tax on their unrelated business income.<sup>115</sup> The legislative history of the 1950 Act provides that “the problem at which the tax on unrelated business income is directed here is primarily that of unfair competition.”<sup>116</sup> Congress decided not to deny or revoke tax-exempt status solely because the organization carried on unrelated active business enterprises, but instead “merely [imposed] the same tax on income derived therefrom as is borne by their competitors.”<sup>117</sup> The Congress excluded from the tax certain passive forms of income, concluding that such passive income was “not likely to result in serious competition for taxable businesses having similar income”<sup>118</sup> and “should not be taxed where it is used for exempt purposes because investments producing

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<sup>112</sup> 96 F.2d 776 (2d Cir. 1938) (holding that a bathing beach business that turned its profits over to a charitable organization was exempt).

<sup>113</sup> 190 F.2d 120 (3d Cir. 1951) (upholding the exempt status of a corporation that acquired the C.F. Mueller pasta company, on the ground that the pasta company’s profits were destined for the New York University School of Law’s exempt programs).

<sup>114</sup> H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

<sup>115</sup> Revenue Act of 1950, Pub. L. No. 81-814, sec. 301. In 1951, Congress extended the unrelated business income tax to the income of State colleges and universities. Sec. 511(a)(2)(B).

<sup>116</sup> H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 28 (1950). The Supreme Court has stated that the “undisputed purpose” of the unrelated business income tax is “to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed.” *United States v. American Bar Endowment*, 477 U.S. 105, 114 (1986); *United States v. American College of Physicians*, 475 U.S. 834, 838 (1986) (“Congress perceived a need to restrain the unfair competition fostered by the tax laws.”).

<sup>117</sup> H.R. Rep. No. 2319, 81st Cong., 2d Sess. 37 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 39 (1950).

<sup>118</sup> S. Rep. No. 2375, 81st Cong., 2d Sess. 30-31 (1950).

incomes of these types have long been recognized as proper for educational and charitable organizations.”<sup>119</sup>

The 1950 Act also taxed as unrelated business income certain rents received in connection with the leveraged sale and leaseback of real estate.<sup>120</sup> Here, Congress cited three objections to such transactions: (1) “the tax-exempt organization is not merely trying to find a means of investing its own funds at an adequate rate of return but is obviously trading on its exemption since the only contribution it makes to the sale and lease is its tax exemption”; (2) unchecked, such transactions could result in exempt organizations owning “the great bulk of the commercial and industrial real estate in the country . . . lower[ing] drastically the rental income included in the corporate and individual income tax bases”; and (3) the “possibility . . . that the exempt organization has in effect sold part of its exemption . . . by . . . paying a higher price for the property or by charging lower rentals than a taxable business could charge.”<sup>121</sup> This provision was a precursor to the present-law tax on unrelated debt-financed income.

### Tax Reform Act of 1969

In the Tax Reform Act of 1969, Congress extended the unrelated business income tax to all exempt organizations described in section 501(c) and 401(a) (except United States instrumentalities).<sup>122</sup> In addition, the 1969 Act expanded the tax on debt-financed income. The provision enacted in 1950 to tax income from certain leveraged sale-leaseback transactions involving real estate had proved ineffective, as taxpayers succeeded in structuring transactions that escaped the reach of the statute.<sup>123</sup>

The Supreme Court considered one such transaction in the *Clay Brown* case.<sup>124</sup> In *Clay Brown*, a corporate business was sold to a charitable organization, which made a small or no down payment and agreed to pay the balance of the purchase price to the former shareholders out of profits from the property. The charity liquidated the corporation and leased the business assets back to the sellers, who formed a new corporation to operate the business. The newly formed corporation paid a large portion of its business profits as deductible “rent” to the charity, which then paid most of these receipts back to the original owners as installment payments on

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<sup>119</sup> H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31 (1950).

<sup>120</sup> There was an exception for rental income from a lease of five years or less.

<sup>121</sup> H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

<sup>122</sup> The tax also applies to certain State colleges and universities and their wholly owned subsidiaries. Sec. 511(a)(2)(B).

<sup>123</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 62.

<sup>124</sup> *Commissioner v. Clay B. Brown*, 380 U.S. 563 (1965).

the initial purchase price. The Supreme Court agreed with the taxpayer's characterization of the transaction. The original owners thereby succeeded in converting business income that would have been taxable at ordinary income rates to capital gains, while the exempt organization acquired the ownership of a business largely or wholly without the investment of its own funds. Thus, under the 1950 legislation, exempt organizations continued to be able to leverage exempt status to buy businesses and investments on credit, often at more than market price, without contributing much if anything to the transaction other than tax exemption.<sup>125</sup>

Citing principally to cases such as *Clay Brown* and the ability of taxable parties to convert ordinary income into capital gain through leveraged sale-leaseback transactions with tax-exempt organizations,<sup>126</sup> the Congress in 1969 expanded the unrelated debt-financed income rules to cover not only certain rents from debt-financed acquisitions of real property, but to tax in addition other debt-financed income such as interest, dividends, other rents, royalties, and certain gains and losses from any type of property. The 1969 Act provided for certain limited exceptions to the tax on debt-financed income, such as where the debt-financed property is related to the organization's exempt functions.

#### Enactment of the real property exception

In the Miscellaneous Revenue Act of 1980, Congress enacted an exception to the debt-financed income rules for certain real property investments by qualified pension trusts (the progenitor of the real property exception, described above). The exception did not apply, however, if any of five situations were present: (1) the acquisition price is not a fixed amount on the acquisition date; (2) the amount of indebtedness is dependent on the revenue, income, or profits derived from the debt-financed property; (3) the property is leased back to the seller (or a related party); (4) the property is acquired from or leased to a related person of the trust; and (5) the seller or person related to the trust provides nonrecourse financing, and the debt is subordinate to any other indebtedness on the property or the debt bore an interest rate significantly lower than that provided by unrelated parties.<sup>127</sup>

Congress believed that such an exception was warranted because "the exemption for investment income of qualified retirement trusts is an essential tax incentive which is provided to tax-qualified plans in order to enable them to accumulate funds to satisfy their exempt purpose – the payment of employee benefits."<sup>128</sup> Real estate investments are attractive "for diversification and to offset inflation. Debt financing is common in real estate investments." In addition, the

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<sup>125</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 62.

<sup>126</sup> S. Rep. No. 552, 91st Cong., 1st Sess. 62-63; H.R. Rep. No. 413, 91st Cong., 1st Sess. 44-46; Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 62.

<sup>127</sup> Compare sec. 514(c)(9)(B)(i)-(v).

<sup>128</sup> S. Rep. No. 96-1036, 96th Cong., 2d Sess. 29 (1980).

exemption provided to pension trusts was appropriate because, unlike other exempt organizations, the assets of such trusts eventually would be “used to pay taxable benefits to individual recipients whereas the investment assets of other [exempt] organizations . . . are not likely to be used for the purpose of providing benefits taxable at individual rates.” In other words, the exemption for qualified trusts generally resulted only in deferral of tax; unlike the exemption for other organizations. Congress also believed that the five limitations placed upon use of the exception would “eliminate the most egregious abuses addressed by the 1969 legislation.”

In the Deficit Reduction Act of 1984, Congress extended the real property exception to educational organizations, finding that “educational organizations generally were unable to avoid taxation on income from real property acquired for investment purposes because few institutions had sufficient assets to purchase property not subject to debt.”<sup>129</sup> At the same time, Congress layered on additional conditions, including an absolute bar on seller financing and an anti-abuse rule in the case of qualified organizations that were partners in partnerships investing in debt-financed real property. The new restrictions were needed because prior law was “inadequate to prevent the shifting of tax benefits between tax-exempt organizations and taxable entities.”<sup>130</sup>

Between 1986 and 1988, Congress introduced and modified rules requiring that investments through a partnership satisfy a prohibition on disproportionate allocations, i.e., the requirements that each partnership allocation have substantive economic effect and that the partnership satisfy the “fractions rule.”<sup>131</sup>

In 1993, Congress relaxed some of the conditions required to meet the real property exception. In general, leasebacks to the seller (or a disqualified person) are allowed if no more than 25 percent of the leasable floor space in a building is leased back and the lease is on commercially reasonable terms.<sup>132</sup> Seller financing is permitted if the financing is on commercially reasonable terms.<sup>133</sup> In addition, the fixed price restriction and the requirement that indebtedness not be paid out of revenue, income, or profits of the acquired property are relaxed for certain sales by financial institutions.<sup>134</sup>

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<sup>129</sup> Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 1151.

<sup>130</sup> *Id.* In the Tax Reform Act of 1986, Congress provided exempt status for certain title holding companies (section 501(c)(25)) and at the same time extended the real property exception to such companies.

<sup>131</sup> Sec. 514(c)(9)(B)(vi) & (E).

<sup>132</sup> Sec. 514(c)(9)(G)(i).

<sup>133</sup> Sec. 514(c)(9)(G)(ii).

<sup>134</sup> Sec. 514(c)(9)(H).

## E. Overview of Ways to Defer Services Income

### 1. Qualified plans

#### In general

Deferred compensation occurs when the payment of compensation to a service provider is deferred for more than a short period after the compensation is earned (i.e., the time when the services giving rise to the compensation are performed). Payment is generally deferred until some specified event, such as the service provider's death, disability, or other termination of services, or is deferred for a specified period of time, such as five or ten years.

The Code provides tax-favored treatment for certain types of employer-sponsored deferred compensation arrangements that are designed primarily to provide employees with retirement income. These arrangements include qualified defined contribution and defined benefit pension plans (sec. 401(a)), qualified annuities (sec. 403(a)), tax-sheltered annuities (sec. 403(b)), savings incentive match plans for employees or "SIMPLE" plans (sec. 408(p)), simplified employee pensions or "SEPs" (sec. 408(k)), and eligible deferred compensation plans of State or local governmental employers (sec. 457(b)). These plans are referred to as qualified retirement plans.

In the case of a qualified retirement plan, employees do not include contributions in gross income until amounts are distributed, even though the arrangement is funded and benefits are nonforfeitable. In the case of a taxable employer, the employer is entitled to a current deduction (within limits) for contributions even though the contributions are not currently included in an employee's income. Contributions to a qualified plan, and earnings thereon, are held in a tax-exempt trust.

Present law imposes a number of requirements on qualified retirement plans that must be satisfied in order for the plan to be qualified and for favorable tax treatment to apply. These requirements include nondiscrimination rules that are intended to ensure that a qualified retirement plan covers a broad group of employees. The nondiscrimination requirements are designed to ensure that qualified retirement plans benefit an employer's rank-and-file employees as well as highly compensated employees.<sup>135</sup> Under a general nondiscrimination requirement, the contributions or benefits provided under a qualified retirement plan must not discriminate in favor of highly compensated employees.<sup>136</sup> Treasury regulations provide detailed and exclusive

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<sup>135</sup> For purposes of the nondiscrimination requirements, an employee is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) either (a) had compensation for the preceding year in excess of \$100,000 (for 2007) or (b) at the election of the employer had compensation for the preceding year in excess of \$100,000 (for 2007) and was in the top 20 percent of employees by compensation for such year (sec. 414(q)). A nonhighly compensated employee is an employee other than a highly compensated employee.

<sup>136</sup> Secs. 401(a)(4), 403(b)(12), 404(a)(2), and 408(k)(3). A qualified retirement plan of a governmental employer is not subject to the nondiscrimination requirements. Special rules apply in the

rules for determining whether a plan satisfies the general nondiscrimination requirement. For example, under the regulations applicable to qualified defined contribution plans and qualified defined benefit plans, the amount of contributions or benefits provided under the plan and the benefits, rights and features offered under the plan must be tested.<sup>137</sup>

Limits also apply on the amount of contributions that can be made to qualified plans and, in the case of defined benefit plans, on the amount that is payable annually from the plan. Limits also apply to the amount of an employer's deduction for contributions to qualified plans.

Qualified employer plans are also generally subject to the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). For example, ERISA generally requires that the assets of a pension plan be held in a trust established for the exclusive purpose of providing plan benefits.

### **Qualified cash or deferred arrangements (section 401(k) plans)**

Under present law, many defined contribution plans include a qualified cash or deferred arrangement (commonly referred to as a "401(k) plan"), under which employees may elect to receive cash or to have contributions made to the plan by the employer on behalf of the employee in lieu of receiving cash. Contributions made to the plan at the election of the employee are referred to as elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual for any taxable year is \$15,500 (for 2007). In applying this limitation, elective deferrals under 401(k) plans, tax-sheltered annuities, SEPs, and SIMPLE plans are aggregated. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a section 401(k) plan. As a result, the dollar limit on elective deferrals is increased for an individual who has attained age 50 by \$5,000 (for 2007). An employee's elective deferrals must be fully vested. A special nondiscrimination test applies to elective deferrals under a 401(k) plan.

### **Tax-sheltered annuities (section 403(b) annuities)**

A tax-sheltered annuity is also permitted to allow a participant to elect to have the employer make payments as contributions to the plan or to the participant directly in cash. As discussed above, the \$15,500 annual limit on elective deferrals applies to elective deferral contributions to a tax-sheltered annuity. As with a 401(k) plan, special rules permit catch-up contributions to be made to a tax-sheltered annuity in the case of certain individuals, and special rules apply for purposes of nondiscrimination testing.

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case of a SIMPLE plan to ensure that a broad group of employees are covered by the plan. Sec. 408(p)(2) and (4).

<sup>137</sup> See Treas. Reg. sec. 1.401(a)(4)-1.

## **Eligible deferred compensation plans of State and local governments (section 457 plans)**

Compensation deferred under a section 457 plan of a State or local governmental employer is includible in income when paid. The maximum annual deferral under such a plan generally is the lesser of (1) \$15,500 (for 2007) or (2) 100 percent of compensation. A special, higher limit applies for the last three years before a participant reaches normal retirement age (the “section 457 catch-up limit”). In the case of a section 457 plan of a governmental employer, a participant who has attained age 50 before the end of the taxable year may also make catch-up contributions up to a limit of \$5,000 (for 2007), unless a higher section 457 catch-up limit applies. Only contributions to section 457 plans are taken into account in applying these limits; contributions made to a qualified retirement plan or section 403(b) plan for an employee do not affect the amount that may be contributed to a section 457 plan for that employee. Thus, for example, a State or local government employee covered by both a section 457 plan and a section 401(k) or 403(b) plan can contribute up to \$15,500 (for 2007) to each plan for a total of \$31,000. In the case of a plan that fails to meet the dollar limitations or any other requirement of section 457 (an “ineligible plan”), compensation is includible in income for the first taxable year in which there is no substantial risk of forfeiture.<sup>138</sup>

## **2. Nonqualified deferred compensation**

### **In general**

A nonqualified deferred compensation arrangement is generally any deferred compensation arrangement that is not a qualified retirement plan. Nonqualified deferred compensation arrangements are contractual arrangements between a service recipient (e.g., an employer or a hedge fund) and a service provider (e.g., an employee or an entity that operates as a hedge fund manager) covered by the arrangement. Such arrangements are structured in whatever form achieves the goals of the parties; as a result, they vary greatly in design. Considerations that may affect the structure of the arrangement are the current and future income needs of the service provider, the desired tax treatment of deferred amounts, and the desire for assurance that deferred amounts will in fact be paid.

ERISA contains exemptions from its requirements for certain nonqualified deferred compensation arrangements. Most nonqualified deferred compensation arrangements are designed to fall within these ERISA exemptions. Thus, nonqualified deferred compensation arrangements are generally not subject to the protections of ERISA. For example, there is no requirement that a nonqualified deferred compensation arrangement be funded by a trust established for the exclusive purpose of providing plan benefits.<sup>139</sup>

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<sup>138</sup> Sec. 457(f).

<sup>139</sup> As discussed later in this section, a participant in a nonqualified deferred compensation plan that is “funded” (such as a plan that is funded by a trust that is established for the exclusive purpose of providing plan benefits) must include vested benefits in gross income. Thus, there is no income deferral with respect to vested benefits in a funded nonqualified deferred compensation arrangement.

The Code and ERISA do not limit the amount that can be deferred by a service provider under a nonqualified deferred compensation arrangement.

## **Tax treatment of service provider**

### In general

The American Jobs Creation Act of 2004<sup>140</sup> added section 409A to the Code which provides specific rules governing the tax treatment of nonqualified deferred compensation.<sup>141</sup> Prior to section 409A, there were no rules that specifically governed the tax treatment of nonqualified deferred compensation. In determining the tax treatment of nonqualified deferred compensation prior to enactment of section 409A, a variety of tax principles and Code provisions were relevant, including the doctrine of constructive receipt, the economic benefit doctrine, the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified employee annuities (sec. 403(c)). Section 409A does not override these tax principles and Code provisions. Thus, they are relevant in determining the tax treatment of nonqualified deferred compensation and are discussed below. Section 409A does not prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided under its rules.

Under section 409A, unless certain requirements are satisfied, amounts deferred under a nonqualified deferred compensation plan are currently includible in income to the extent not subject to a substantial risk of forfeiture. The requirements imposed under section 409A affect the way that nonqualified deferred compensation arrangements are now commonly structured.

### General income inclusion rules

In the case of a cash-basis taxpayer, if the nonqualified deferred compensation arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451 (unless earlier income inclusion applies under section 409A).<sup>142</sup> Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it may be drawn on at any time.<sup>143</sup> Income is not constructively received if the taxpayer's control of its receipt is subject to

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<sup>140</sup> Pub. L. No. 108-357 (2004).

<sup>141</sup> Section 409A generally applies to amounts deferred after December 31, 2004.

<sup>142</sup> In contrast, if the taxpayer uses an accrual method of accounting, compensation is includible in gross income when all events have occurred which fix the right to receive such compensation and the amount thereof can be determined with reasonable accuracy. Treas. Reg. secs. 1.451-1 and 1.451-2.

<sup>143</sup> Compensation that is constructively received is includible in income regardless of whether the requirements of section 409A are met.

substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Section 83 provides rules for the tax treatment of property transferred in connection with the performance of services and generally applies to a funded nonqualified deferred compensation arrangement.<sup>144</sup>

The economic benefit doctrine is based on the broad definition of gross income in the Code (sec. 61), which includes income in whatever form paid. Under the economic benefit doctrine, if an individual receives any economic or financial benefit or property as compensation for services, the value of the benefit or property is includible in the individual's gross income. For example, courts have applied the economic benefit doctrine to the receipt of stock options or the receipt of an interest in a trust.<sup>145</sup> A concept related to economic benefit is the cash equivalency doctrine.<sup>146</sup> Under this doctrine, if the right to receive a payment in the future is reduced to writing and is transferable, such as in the case of a note or a bond, the right is considered to be the equivalent of cash and the value of the right is includible in gross income.<sup>147</sup>

#### Section 409A

In general.—Under section 409A, all amounts deferred by a service provider under a nonqualified deferred compensation plan<sup>148</sup> for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture<sup>149</sup> and not previously included

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<sup>144</sup> Special rules apply under the Code in the case of nonexempt employee trusts and nonqualified employee annuities (i.e., trusts and annuities not meeting the requirements applicable to qualified retirement plans and annuities). Secs. 402(b) and 403(c). These provisions apply rules similar to those under section 83. Although these Code provisions predate the enactment of section 83 in 1969, they were amended at that time to reflect the enactment of section 83.

<sup>145</sup> *Commissioner v. Smith*, 324 U.S. 177 (1945); *E.T. Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (1952).

<sup>146</sup> In the case of nonqualified deferred compensation arrangements, these doctrines have largely been codified in the Code provisions discussed herein. However, because many of the legal precedents related to nonqualified deferred compensation predate these Code provisions, the economic benefit and cash equivalency doctrines are sometimes considered in analyzing the tax treatment of nonqualified deferred compensation.

<sup>147</sup> *See, e.g., Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961).

<sup>148</sup> A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person. Amounts deferred also include actual or notional earnings.

<sup>149</sup> As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

in gross income, unless certain requirements are satisfied. If the requirements of section 409A are not satisfied, in addition to current income inclusion, interest at the rate applicable to underpayments of tax plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

Under regulations, the term “service provider” includes an individual, corporation, subchapter S corporation, partnership, personal service corporation (as defined in sec. 269A(b)(1)), noncorporate entity that would be a personal service corporation if it were a corporation, or qualified personal service corporation (as defined in sec. 448(d)(2)) for any taxable year in which such individual or entity accounts for gross income from the performance of services under the cash receipts and disbursements method of accounting.<sup>150</sup> Section 409A does not apply to a service provider that provides significant services to at least two service recipients that are not related to each other or the service provider. This exclusion does not apply to a service provider who is an employee or a director of a corporation (or similar position in the case of an entity that is not a corporation).<sup>151</sup> In addition, the exclusion does not apply to an entity that operates as the manager of a hedge fund or private equity fund. This is because the exclusion does not apply to the extent that a service provider provides management services to a service recipient. Management services for this purpose means services that involve the actual or de facto direction or control of the financial or operational aspects of a trade or business of the service recipient or investment management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets, such as a hedge fund.<sup>152</sup>

For purposes of section 409A, a nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan<sup>153</sup> or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

The regulations also provide that certain other types of plans are not considered deferred compensation, and thus are not subject to section 409A. For example, if a service recipient transfers property to a service provider, there is no deferral of compensation merely because the value of the property is either not includible in income under section 83 by reason of the property being substantially nonvested or is includible in income because of a valid section 83(b)

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<sup>150</sup> Treas. Reg. Sec. 1.409A-1(f)(1).

<sup>151</sup> Treas. Reg. Sec. 1.409A-1(f)(2).

<sup>152</sup> Treas. Reg. Sec. 1.409A-1(f)(2)(iv).

<sup>153</sup> A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE. A qualified governmental excess benefit arrangement (sec. 415(m)) is a qualified employer plan. An eligible deferred compensation plan (sec. 457(b)) is also a qualified employer plan. A tax-exempt or governmental deferred compensation plan that is not an eligible deferred compensation plan is not a qualified employer plan.

election.<sup>154</sup> Another exception applies to amounts that are not deferred beyond a short period of time after the amount is no longer subject to a substantial risk of forfeiture.<sup>155</sup> Under this exception, there generally is no deferral for purposes of section 409A if the service provider actually or constructively receives the amount on or before the last day of the applicable 2½ month period. The applicable 2½ month period is the period ending on the later of the 15th day of the third month following the end of: (1) the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture; or (2) the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture. Special rules apply in the case of stock options.<sup>156</sup>

The regulations provide exclusions from the definition of nonqualified deferred compensation for individuals who participate in certain foreign plans, including plans covered by an applicable treaty and broad-based foreign retirement plans.<sup>157</sup> In the case of a U.S. citizen or lawful permanent alien, nonqualified deferred compensation does not include a broad-based foreign retirement plan, but only with respect to the portion of the plan that provides for nonelective deferral of foreign earned income and subject to limitations on the annual amount deferred under the plan or the annual amount payable under the plan. In general, foreign earned income refers to amounts received by an individual from sources within a foreign country that constitutes earned income attributable to services.

Permissible distribution events.—Under section 409A, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary), death, a specified time (or pursuant to a fixed schedule), change in control of a corporation (to the extent provided by the Secretary), occurrence of an unforeseeable emergency, or if the participant becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and, except as provided in regulations by the Secretary, may not permit acceleration of a distribution. In the case of a specified employee who separates from service, distributions may not be made earlier than six months after the date of the separation from service or upon death. Specified employees are key employees<sup>158</sup> of publicly-traded corporations.

Deferral elections.—Section 409A requires that a plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other

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<sup>154</sup> Treas. Reg. Sec. 1.409A-1(b)(6).

<sup>155</sup> Treas. Reg. Sec. 1.409A-1(b)(4).

<sup>156</sup> Treas. Reg. Sec. 1.409A-1(b)(5).

<sup>157</sup> Treas. Reg. Sec. 1.409A-1(a)(3).

<sup>158</sup> Key employees are defined in section 416(i) and generally include officers (limited to 50 employees) having annual compensation greater than \$145,000 (in 2007), five percent owners, and one percent owners having annual compensation from the employer greater than \$150,000.

time as provided in Treasury regulations. In the case of any performance-based compensation based on services performed over a period of at least 12 months, such election may be made no later than six months before the end of the service period. The time and form of distributions must be specified at the time of initial deferral. A plan may allow changes in the time and form of distributions subject to certain requirements.

**Back-to-back arrangements.**—Back-to-back service recipients (i.e., situations under which an entity receives services from a service provider such as an employee, and the entity in turn provides services to a client) that involve back-to-back nonqualified deferred compensation arrangements (i.e., the fees payable by the client are deferred at both the entity level and the employee level) are subject to special rules under section 409A. For example, the final regulations generally permit the deferral agreement between the entity and its client to treat as a permissible distribution event those events that are specified as distribution events in the deferral agreement between the entity and its employee. Thus, if separation from employment is a specified distribution event between the entity and the employee, the employee’s separation is a permissible distribution event for the deferral agreement between the entity and its client.<sup>159</sup>

### **Timing of the service recipient’s deduction**

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.<sup>160</sup> Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the service provider is deductible by the service recipient for the taxable year in which the amount is includible in the service provider’s income.<sup>161</sup>

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<sup>159</sup> Treas. Reg. Sec. 1.409A-3(i)(6).

<sup>160</sup> Secs. 404(a)(5), (b) and (d) and sec. 83(h).

<sup>161</sup> In the case of a publicly held corporation, no deduction is allowed for a taxable year for remuneration with respect to a covered employee to the extent that the remuneration exceeds \$1 million. Code sec. 162(m). The Code defines the term “covered employee” in part by reference to Federal securities law. In light of changes to Federal securities law, the Internal Revenue Service interprets the term covered employee as the principal executive officer of the taxpayer as of the close of the taxable year or the 3 most highly compensated employees of the taxpayer for the taxable year whose compensation must be disclosed to the taxpayer’s shareholders (other than the principal executive officer or the principal financial officer). Notice 2007-49, 2007-25 I.R.B. 1429. For purposes of the deduction limit, remuneration generally includes all remuneration for which a deduction is otherwise allowable, although commission-based compensation and certain performance-based compensation are not subject to the limit. Remuneration does not include compensation for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (e.g., is not performance-based compensation) because the payment of the compensation is deferred until after termination of employment.

## **Employment taxes and reporting**

In the case of an employee, nonqualified deferred compensation is generally considered wages both for purposes of income tax withholding and for purposes of taxes under the Federal Insurance Contributions Act (“FICA”), consisting of social security tax and Medicare tax. However, the income tax withholding rules and social security and Medicare tax rules that apply to nonqualified deferred compensation are not the same.

In the case of an employee, nonqualified deferred compensation is generally subject to income tax withholding at the time it is includible in the employee’s income as discussed above. In addition, amounts includible in income are required to be reported on the employee’s Form W-2 for the year includible in income. Income tax withholding and Form W-2 reporting are required even if the employee has already terminated employment. Income tax withholding and Form W-2 reporting are required when amounts are includible in income even if no actual payments are made to the employee.<sup>162</sup>

In the case of a service provider who is not an employee, nonqualified deferred compensation amounts includible in income generally are required to be reported on a Form 1099 for the year includible in income. Income tax withholding generally does not apply to such amounts.

The Code provides special rules for applying social security and Medicare taxes to nonqualified deferred compensation of employees.<sup>163</sup> In general, nonqualified deferred compensation is subject to social security and Medicare tax when it is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by the timing of income inclusion.

In the case of a self-employed individual, nonqualified deferred compensation amounts that are includible in income are also taken into account in determining net earnings from self-employment for social security and Medicare tax purposes unless an exception applies.

The Code requires annual reporting to the IRS of amounts deferred even if such amounts are not currently includible in income for that taxable year.<sup>164</sup> The IRS has postponed the

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<sup>162</sup> The required income tax withholding is accomplished by withholding income taxes from other wages paid to the employee in the same year.

<sup>163</sup> Because nonqualified deferred compensation arrangements generally cover only highly paid employees, the other compensation paid to the employee during the year generally exceeds the social security wage base. In that case, nonqualified deferred compensation amounts are subject only to Medicare tax.

<sup>164</sup> Sec. 6051(a)(13).

effective date of the statutory requirement and announced that an employer (or other payor) is not required for 2005 and 2006 to report amounts deferred during the year under a nonqualified deferred compensation plan subject to section 409A.<sup>165</sup>

## **Offshore arrangements**

### **In general**

The requirements under section 409A apply in the case of deferred compensation of a U.S. person participating in offshore operations such as a hedge fund located outside of the U.S. The general requirements of section 409A (i.e., the rules relating to elections, distributions and no acceleration of benefits) apply similarly to U.S. persons whether their activities are conducted in the United States or abroad.<sup>166</sup>

### **Foreign trusts**

Section 409A requires current income inclusion in the case of certain offshore funding of nonqualified deferred compensation. Under section 409A, in the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 (whether or not such assets are available to satisfy the claims of general creditors) at the time set aside if such assets (or trust or other arrangement) are located outside of the United States or at the time transferred if such assets (or trust or other arrangement) are subsequently transferred outside of the United States. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property.

Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts set aside been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 20-percent tax.

The provision does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction. The Secretary has authority to exempt arrangements from the provision if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

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<sup>165</sup> Notice 2006-100, 2006-51 I.R.B. 1109.

<sup>166</sup> As discussed above, exceptions apply in the case of certain foreign plans.

### **III. LEGISLATIVE PROPOSALS IN RECENT CONGRESSES**

#### **A. Proposals Relating to Offshore Reinsurance**

##### **H.R. 1755 (107th Congress)**

H.R. 1755, “Reinsurance Tax Equity Act of 2001,” was introduced in the House of Representatives by Nancy Johnson and Richard Neal during the 107th Congress on May 8, 2001. The bill would amend section 832(b)(4) of the Code to deny a deduction for premiums paid for direct or indirect reinsurance of U.S. risks with a “related insurer” in certain circumstances. However, when calculating its taxable income, an insurance company may generally deduct reinsurance recovered from a related insurer to the extent a deduction for the premium paid for the reinsurance was disallowed as a result of the bill. A U.S. risk includes any risk related to property in the United States, or liability arising out of the activity in, or in connection with the lives or health of residents of, the United States. A “related insurer” means a reinsurer owned or controlled directly or indirectly by the same interests (within the meaning of section 482) as the person making the premium payment.

The deduction is not denied if: (1) the income attributable to the reinsurance to which such premium relates is includible in the gross income of such reinsurer or one or more domestic corporations or citizens or residents of the United States; or (2) the related insurer establishes to the satisfaction of the Treasury Secretary that the taxable income (as determined under section 832) attributable to the reinsurance is subject to an effective rate of income tax imposed by a foreign country greater than 20 percent of the maximum rate specified in section 11 of the Code. A related insurer may elect to treat income from the reinsurance of U.S. risks, which is not otherwise includible in gross income, as income that is effectively connected with the conduct of a U.S. trade or business.

##### **H.R. 4192 (106th Congress)**

H.R. 4192 was introduced in the House of Representatives by Nancy Johnson and Richard Neal during the 106th Congress on April 5, 2000. This bill would amend section 845 to alter the treatment of related-party reinsurance. Under the bill, if a domestic person directly or indirectly reinsures a United States risk with a related foreign reinsurer, then the investment income of the domestic person shall be increased each year by an amount equal to the product of (1) the average of the applicable federal mid-term rates determined under section 1274(d)(1) and (2) the sum of the reserves and liabilities related to the U.S. risks ceded to the foreign reinsurer as shown on the national statement approved by the National Association of Insurance Commissioners. A U.S. risk includes any risk related to property in the United States, or liability arising out of the activity in, or in connection with the lives or health of residents of, the United States. An insurer is a “related foreign insurer” with respect to any domestic person if such person and foreign insurer are owned or controlled directly or indirectly by the same interest (within the meaning of section 482).

Generally, this rule is not applicable if: (1) the foreign reinsurer retaining the reinsurance includes the income attributable to the reinsurance of the U.S. risks on its U.S. tax return either as a result of having made an election to be taxed as a domestic insurance company under section

953(d) or because such income is effectively connected with the foreign reinsurer's U.S. trade or business; (2) the foreign reinsurer elects to file a tax return and pay tax on income from the reinsurance of U.S. risks ceded to it by related domestic persons as if such income were effectively connected to a U.S. trade or business; (3) one or more domestic corporations or U.S. individuals include the income attributable the reinsurance of the U.S. risks ceded to the related foreign reinsurer on its tax return under subpart F; or (4) the foreign reinsurer establishes to the satisfaction of the Treasury Secretary that the taxable income (as determined under section 832) attributable to the reinsurance is subject to an effective rate of income tax imposed by a foreign country greater than 20 percent of the maximum rate specified in section 11 of the Code.

The 1 percent excise tax on premiums paid to foreign reinsurers does not apply to premiums to which the bill applies.

## **B. Proposal Relating to Unrelated Debt-Financed Income**

### **H.R. 3501 (110th Congress)**

H.R. 3501 was introduced in the House of Representatives by Sander Levin during the 110th Congress on September 7, 2007. The bill amends section 514(c) of the Code to provide an exception to the unrelated debt-financed income rules for certain investments by tax-exempt organizations in qualified securities or commodities. Specifically, the bill provides that, where a tax-exempt organization is a limited partner in a partnership that holds qualified securities or commodities, indebtedness incurred or continued by the partnership in purchasing or carrying any such asset will not be “acquisition indebtedness” for purposes of the debt-financed income rules. Qualified securities and commodities generally include securities described in section 475(c)(2) of the Code, commodities described in section 475(e)(2) of the Code, and any option or derivative contract with respect to such a security or commodity.

To qualify for the exception for investments in qualified securities or commodities, the partnership must satisfy the special rules that apply to investments in partnerships under the present-law real estate exception to the debt-financed income rules. The Secretary is given the authority to issue regulations providing for certain other anti-abuse rules as necessary or appropriate to carry out the purposes of the bill.

## IV. ISSUES AND ANALYSIS

### A. Issues and Analysis Relating to Reinsurance

#### In general

Both domestically-controlled and foreign-controlled insurance companies regularly cede a portion of their U.S. risks to affiliated or unaffiliated U.S. or foreign reinsurers. In general, the shifting, distribution, and geographic diversification of risks that may be accomplished by ceding such risks are valid business purposes. Further, ceding U.S. risks to foreign reinsurers generally serves a valid business purpose of minimizing multiple layers of regulation and consolidating regulatory oversight authority in a more business-favorable jurisdiction.

The industry recognizes, however, that some companies may take such reinsurance activities to the limit. A business arrangement under which an insurer cedes most of its risks to one reinsurer is known in the industry as “fronting.” Fronting raises issues of whether the insurer is acting as an agent of the reinsurer, and whether a foreign reinsurer is engaged in a trade or business in the United States, and if so, whether the activities result in the reinsurer having a permanent establishment in the United States to which the ceded premiums are attributable.

In the case of foreign-based companies that reinsure policies issued or reinsured by independent or affiliated U.S. insurance companies, a well-advised reinsurer may in most cases avoid being engaged in a trade or business and having a permanent establishment in the United States by not having an office in the United States, by keeping separate the affairs of the foreign and U.S. companies, and by carefully following the formalities of contracts. In that case, the U.S. insurer may deduct its reinsurance premiums; those premiums are subject to neither net income nor withholding tax by the United States, notwithstanding that the reinsurance covers U.S. risks. The tax cost of such an arrangement is the one-percent excise tax on the reinsurance premiums,<sup>167</sup> plus any U.S. income tax imposed on ceding commissions paid by the reinsurer to the ceding insurer. The premiums may or may not be subject to tax in the country in which the foreign reinsurer is resident, depending on the tax law there; generally this income is lightly taxed in the countries most frequently availed of, compared to U.S. tax rates.<sup>168</sup> Further, because the premiums are actually paid to the foreign reinsurer, it may invest these funds, including in the United States. In so doing, it may avail itself of potentially low local tax rates,<sup>169</sup> as well as, in the case of U.S. investment, the “securities trading safe harbor” tax exemption of section 864(b)

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<sup>167</sup> Sec. 4371. The U.S.-Switzerland, U.S.-United Kingdom, and U.S.-Germany tax treaties, but neither the U.S.-Bermuda nor U.S.-Barbados tax treaty, generally provide an exemption from the excise tax for reinsurance premiums paid to residents of Switzerland, the United Kingdom, and Germany, respectively. See the Present Law section on International Taxation.

<sup>168</sup> In the case of Bermuda, for example, the reinsurance premium is not taxed by Bermuda.

<sup>169</sup> In the case of Bermuda, for example, the investment income is not taxed by Bermuda.

and other portfolio investment exemptions.<sup>170</sup> At the same time, a related foreign reinsurer's consolidated financial statements are not affected by such related-party reinsurance transactions.

The above tax profile is in contrast to that of U.S.-based reinsurers, whose U.S. companies' income is subject to taxation in the United States when earned and whose controlled foreign corporations' insurance income is generally subject to U.S. tax under subpart F.<sup>171</sup> The distribution of share ownership of a foreign corporation may determine, in part, whether it and its foreign subsidiaries are subject to the controlled foreign corporation tax regime or is able to obtain the superior tax treatment accorded other foreign corporations. A foreign corporation that is majority-owned, or even 100-percent-owned, directly or indirectly, by U.S. persons is not a controlled foreign corporation if its ownership is dispersed such that the majority of the voting power or value of the foreign corporation is not owned, directly or indirectly, by U.S. persons owning 10 percent or more of the voting power of the corporation's stock.

### **Earnings stripping**

In the case of the systematic reduction of the U.S. tax base of a U.S. foreign controlled company ("FCC") by its foreign parent by means of interest deductions – known as earnings stripping – Congress has provided a set of rules that disallow deductions for amounts of interest deemed to be excessive.<sup>172</sup> The rules apply regardless of the taxpayer's or related creditor's intent or the existence of a valid business purpose for such debt. Indeed, it may be presumed that the debt qualifies as such under general debt-equity principles and that there is a valid business purpose for such debt. The earnings stripping rules operate in a mostly mechanical fashion to disallow the portion of the FCC's interest deduction over a certain threshold. The disallowed deductions may be carried forward indefinitely for use in future years.

The earnings stripping rules are generally not affected by U.S. income tax treaties because they affect residents of the United States, not residents of treaty countries. When it enacted these rules, Congress did not believe they violated U.S. treaty obligations. The Committee on Ways and Means stated that "[t]he committee does not believe that the impact of this limitation on foreign-owned entities violates any treaty nondiscrimination provision....If the committee should be incorrect in its technical interpretation of the interaction between this

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<sup>170</sup> The cumulative benefits of such low-taxed or nontaxed investment may be greater in the case of longer-term investments, such as the investment of premiums from long-tail lines.

<sup>171</sup> In general, income from related-party reinsurance and reinsurance of U.S. risks are not exempt from subpart F. Secs. 953(e) and 954(i). See discussion of these rules in the Present Law section.

<sup>172</sup> Sec. 163(j). Those rules are discussed in the Present Law section. The President's budget for the past several years has included a proposal to further restrict certain related-party interest deductions. See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2008 Budget Proposal* (JCS-2-07), March 21, 2007, at 209.

provision and U.S. treaties, however, it does not intend that any contrary treaty provision defeat its purpose in enacting this limitation.”<sup>173</sup>

### Foreign related-party reinsurers and earnings stripping

Earnings stripping transactions can involve the payment of deductible amounts other than interest.<sup>174</sup> Even though interest earnings stripping is not a perfect analogy to reinsurance in every detail, the effects on the U.S. tax base of an FCC that reinsures U.S. risks with its foreign parent companies or foreign related parties is the same as earnings stripping. The Reasons for Change for the earnings stripping rules in the Ways and Means committee Report sets forth general principles that appear to be equally applicable to foreign related party reinsurance:

The committee believes, as a general matter, that it is appropriate to limit the deduction for interest that a taxable person pays or accrues to a tax-exempt entity whose economic interests coincide with those of the payor. To allow an unlimited deduction for such interest permits significant erosion of the tax base. Allowance of unlimited deductions permits an economic unit that consists of more than one legal entity to contract with itself at the expense of the government.

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The committee is particularly concerned that this ability to avoid tax tends to give an unfair advantage to business operations owned by foreign and other tax-exempt persons, as compared with business operations owned by taxable U.S. persons. In addition, such an advantage may enhance foreign investors’ abilities to take over U.S. businesses, inasmuch as their reduced tax burden permits such investors to pay a higher price for a U.S. business than competing taxable domestic investors can pay. The committee believes that all such potential investors in U.S. businesses should compete on a level basis.<sup>175</sup>

If the rationale for the earnings stripping rules applies to foreign related-party reinsurance transactions, then it should be possible to devise a set of rules analogous to those of section 163(j) that would disallow, and possibly defer, deductions for ceding “excessive” reinsurance

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<sup>173</sup> H.R. Rep. No. 101-247, 101<sup>st</sup> Cong., 1<sup>st</sup> Sess. 1249 (1989). *See also* Omnibus Budget Reconciliation Act of 1989, Conference Report, H.R. Rep. No. 101-386, 101<sup>st</sup> Cong., 1<sup>st</sup> Sess. 568 (“The conferees believe that the conference agreement does not violate treaties.”)

<sup>174</sup> *See* Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President’s Fiscal Year 2008 Budget Proposal* (JCS-2-07), March 21, 2007, at 210.

<sup>175</sup> H.R. Rep. No. 101-247, 101<sup>st</sup> Cong., 1<sup>st</sup> Sess. 1241, 1242 (1989).

premiums covering U.S. risks paid by FCCs to foreign related persons, notwithstanding any current tax treaty provision.<sup>176</sup>

Despite the broad similarity between earnings stripping and foreign related-party reinsurance transactions, such reinsurance rules would not be identical to the earnings stripping rules because the two factual patterns are not identical. For example, by ceding premiums, an insurer generally decreases its financial leverage and debt-equity ratio, unlike the earnings stripping-by-debt scenario, in which these are increased. The ceding of premiums thus increases the ceding company's financial and regulatory capacity to write (or reinsure) more premiums, which may, in turn, be ceded. This creates a business incentive for an FCC and its foreign parent company to engage in or to increase fronting-type activities.

In general, such a reinsurance provision would disallow deductions for premiums for U.S. risk ceded to tax-exempt related persons. A person would be considered tax-exempt to the extent of a treaty or Code reduction in withholding or other tax, including the elimination of withholding tax on premiums under Treasury Regulation section 1.1441-2(a)(7),<sup>177</sup> taking into account the imposition of the one-percent excise tax on reinsurance premiums. One general approach might be to closely follow the rules of section 163(j) to disallow a deduction for the amount of reinsurance premiums paid to foreign related parties to the extent the amount of reinsured premiums exceeds 50% of an amount similar to "adjusted taxable income."<sup>178</sup> As in the case of interest earnings stripping, disallowed deductions and an attribute analogous to "excess limitation" could be carried forward from prior years and taken into account.<sup>179</sup>

The earnings stripping rules do not apply unless the FCC's debt-to-equity exceeds a safe-harbor ratio of 1.5 to 1.<sup>180</sup> This amount is generally designed to be greater than the median debt-to-equity ratio of U.S. corporations.<sup>181</sup> As in the case of earnings stripping rules, providing an overall safe harbor could protect the companies from disallowance of deductions due to year-to-year changes in profitability. Such a safe harbor could be based on concepts analogous to the debt-equity ratio, for example, a median percentage of premiums ceded to unrelated parties on a group basis. This could be determined on the basis of overall industry transactions pertaining to

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<sup>176</sup> Such rules could also be applied to related party guarantee or conduit arrangements that are similar in effect to back-to-back loans.

<sup>177</sup> See discussion of withholding taxes in the Present Law section on International Taxation.

<sup>178</sup> Sec. 163(j)(6)(A). Adjusted taxable income is the taxpayer's taxable income computed without regard to any deductions for net interest expense, net operating losses, income attributable to domestic production activities, depreciation, amortization, depletion, and adjustments provided in regulations.

<sup>179</sup> Sec. 163(j)(1)(B) and (2)(B)(ii)-(iii). Excess limitation is the excess of 50 percent of adjusted taxable income over the amount of net interest expense (which is interest expense less interest income).

<sup>180</sup> Sec. 163(j)(2)(A)(ii).

<sup>181</sup> H. R. Rep. No. 101-386, 101<sup>st</sup> Cong., 1<sup>st</sup> Sess. 567 (1989).

unrelated party transactions, by lines of business, or based on some fixed criteria (as in section 163(j)).

An alternative line-drawing approach might be to attempt to match up the FCC's premium-ceding tax burden with the tax burden that is imposed on U.S.-based insurers ceding premiums to their controlled foreign corporations. Proponents of such an approach might view this type of equalization approach as an opportunity to reform or reduce the current system of subpart F taxation of insurance income.<sup>182</sup>

#### Discussion of earnings stripping approach

Some would argue that such a set of reinsurance-stripping rules is necessary to place U.S.-owned and FCC insurance companies on a level playing field, and that it is important to prevent other forms of earnings stripping in addition to interest. Others would argue that since there is a business purpose for such reinsurance, there should not be a formulaic limit imposed on deductions for ceded premiums. Applying a more equal amount of tax with respect to the insurance and reinsurance of U.S. risks does, in fact, level the playing field, but only with respect to tax. Some would argue that such a set of rules would cause property and casualty insurance coverage to become more difficult to obtain or would make such coverage much more expensive. Some proponents of this view might caution that the availability of appropriate insurance coverage at a reasonable cost, particularly catastrophic coverage, is a critical element in today's economy, and that adding any additional tax burden upon such insurers would put such availability at serious risk. Others would argue that the U.S. property and casualty market would not be disrupted thereby and would not become more expensive than the premiums currently charged by U.S. insurers who are unable to cede their premiums to an untaxed or low-taxed foreign parent. These proponents might point to foreign manufacturers such as Toyota and Honda, which have built several factories in the United States since the earnings stripping rules were imposed in 1989, and which are still manufacturing and selling goods in the U.S. market notwithstanding those rules.

Some would find the imposition of an earnings stripping-type provision to address related party reinsurance attractive because it would provide a degree of built-in flexibility to permit an appropriate level of business-driven reinsurance arrangements. Proponents might also suggest that, because it is possible for FCCs to engage simultaneously in both related party reinsurance transactions and earnings stripping using interest deductions, it would also be necessary to coordinate the two sets of rules, and that it is generally simpler to coordinate similar rules. Such coordination rules might also serve a policy objective of better equalizing the U.S. tax burden for the foreign insurance industry compared to other foreign industries.

Another potential benefit of an earnings stripping-type regime is that it would minimally interfere with the operation of tax treaties and therefore it would be difficult or impossible to avoid such a regime by using a tax treaty. Others might argue that such rules violate the spirit, if not the letter, of tax treaties. In addition, since earnings stripping-type rules are not dependent

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<sup>182</sup> Secs. 953 and 954(i). These Code sections are described in the Present Law section of this document.

upon tax treaties or foreign effective tax rates, the impact of an earnings stripping regime may not be circumvented by moving foreign reinsurance operations to another foreign country.

### Deduction disallowance<sup>183</sup>

A related approach is to disallow deductions to the insurer for premiums paid for the direct or indirect reinsurance of U.S. risks with a related foreign reinsurer. Under this approach, the entire amount of the deduction for reinsurance premiums is disallowed, while neither a safe harbor analogous to the 1.5 to 1 debt-equity ratio safe harbor of section 163(j) nor a carryforward of the disallowed deductions is permitted. However, this approach provides an exception for reinsurance premiums subject to income tax by a foreign country at an effective rate greater than 20 percent of the maximum rate of tax specified in section 11, i.e., greater than seven percent.

Opponents of this approach argue that the effective tax rate test unfairly favors certain countries' reinsurers while disfavoring those in other countries,<sup>184</sup> and that different taxpayers may calculate effective tax rates differently. They further argue that, by not providing a safe harbor, this approach operates harshly against all foreign related party reinsurance, even though there may be an important business purpose for reinsuring at least some risks in this manner. Proponents argue that such measures are necessary in order to terminate the tax planning opportunities available only to FCCs and their foreign affiliates and that it is appropriate to set a minimum effective rate of foreign tax to ensure that such reinsurance is equitably burdened with tax in some jurisdiction.

### Other alternatives

Another possible way to address the differential taxation of U.S. and foreign-based reinsurers might be to lower the U.S. corporate income tax rate on domestic reinsurers (or on domestic insurance in general) or to provide other incentives with similar effects. Such benefits could possibly be limited to certain lines of business. However, such actions would have very little effect on the underlying business purposes claimed by such reinsurers.

Alternatively, a combination of decreasing the U.S. tax burden on domestic reinsurance (or on domestic insurance in general) and adding some restrictive rules designed to preserve the U.S. tax base might increase the likelihood of preserving the U.S. insurance and reinsurance industry and inducing the return to the U.S. of some foreign-based reinsurers that may pay little or no U.S. tax but still have a large business presence in the U.S. However, others might view this approach as an unwarranted and unfair preference of one industry or industry segment over others due to the mobility of such income, and, accordingly, not effective tax policy.

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<sup>183</sup> This approach is similar to H.R. 1755 (107<sup>th</sup> Congress), described in the section of this document entitled Legislative Proposals in Recent Congresses.

<sup>184</sup> Reportedly, the effective tax rate test results in an exemption for Swiss reinsurers; clearly it does not exempt Bermuda reinsurers.

## U.S.-Bermuda tax treaty

Another possible option for consideration is to address Bermuda-based reinsurers, in part by terminating the U.S.-Bermuda income tax treaty pertaining to insurance and mutual assistance.<sup>185</sup> That treaty is unique in that it provides no tax benefits for residents of the United States and therefore is a departure from the tax treaty model of reciprocal tax benefits.<sup>186</sup> In addition, the U.S.-Bermuda tax treaty, like most U.S. tax treaties, contains anti-treaty-shopping rules intended to prevent residents of third countries from receiving benefits under the treaty. Unlike most U.S. tax treaties, however, the U.S.-Bermuda treaty's anti-treaty-shopping rules do not disqualify Bermuda companies from benefits on the basis of substantial U.S. ownership. This raises the question whether a U.S. tax treaty should provide an incentive to U.S. persons to locate their businesses outside the United States in order to obtain U.S. tax treaty benefits.<sup>187</sup>

Terminating the U.S.-Bermuda insurance tax treaty, however, might by itself have little or no effect on Bermuda reinsurers, because Bermuda reinsurance companies that do not have a permanent establishment in the United States also might not be engaged in a trade or business in the United States (or might be able to alter their activities to avoid being engaged in a U.S. trade or business).<sup>188</sup> Moreover, Treasury Regulation section 1.1441-2(a)(7) precludes the United States from imposing withholding tax on insurance premiums paid with respect to contracts subject to the section 4371 excise tax (which includes reinsurance premiums ceded to Bermuda companies).

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<sup>185</sup> The treaty is actually between the United States and the United Kingdom and is titled *Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda) relating to the Taxation of Insurance Enterprises and Mutual Assistance in Tax Matters*.

<sup>186</sup> See Joint Committee on Taxation, *Prepared Statement of H. Patrick Oglesby, Foreign Tax Counsel, Alan L. Fischl, Legislation Attorney, and Stephen M. Parks, Accountant, Staff of the Joint Committee on Taxation Hearing on Proposed Tax Treaty With Bermuda Before the Senate Committee on Foreign Relations, September 25, 1986 (JCX-26-86), September 24, 1986* ("JCT 1986 Statement"). While Article 5 of that treaty provides in summary form for mutual assistance in tax matters and Article 6 for confidentiality relating to such matters, and an exchange of notes provided substantial details in these areas, in 1988 the United States and Bermuda entered into a more complete agreement for the exchange of tax information, titled *Agreement between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda) for the Exchange of Information with Respect to Taxes*. These two treaties with the United States are the only tax treaties that Bermuda currently has in force. Of course, before taking any action with respect to the U.S.-Bermuda tax treaty, it would be important to determine what that treaty provides in the area of mutual assistance now that the exchange of information agreement is in effect.

<sup>187</sup> JCT 1986 Statement at 4. The U.S.-Barbados tax treaty, which the JCT 1986 Statement compared with the U.S.-Bermuda tax treaty, was amended by a protocol in 2004. See JCT 1986 Statement at 5; discussion of U.S.-Barbados tax treaty in the Present Law section on International Taxation.

<sup>188</sup> Even if terminating the U.S.-Bermuda tax treaty would have little practical effect, its termination might be viewed as an indication of U.S. tax treaty policy.

In combination with terminating the U.S.-Bermuda insurance tax treaty, the regulation cited above could be overridden by new legislation and withholding could be imposed upon payments of reinsurance premiums to Bermuda reinsurers in lieu of imposing the section 4371 excise tax. A key economic question would be to determine an appropriate rate of withholding (between 1 and 30 percent) that would fairly tax the reinsurers' profits from insuring U.S. risks. In connection with these more significant changes, it would be desirable or necessary to consider the interaction of such withholding rules with other treaties and to equalize the treatment of Bermuda and other foreign reinsurers.<sup>189</sup> Alternatively, different withholding rates could be applied to short-tail versus long-tail coverage. However, this could be quite complex in practice.

#### Reinsurance excise tax

Another alternative that might be considered would be to increase the foreign reinsurance excise tax rates generally and coordinate them with the tax treaties, including possibly applying higher rates on certain long-tail coverage.<sup>190</sup> The underlying principle for all these measures is that income from insuring U.S. risks should generally be subject to U.S. tax, regardless of a taxpayer's legal entity and contractual structure.

#### Transfer pricing

The growth from 2001 to 2006 in the amount of premiums ceded to unaffiliated offshore reinsurers as compared with affiliated offshore reinsurers (4.7 versus 104.4 percent)<sup>191</sup> suggests that related parties may be ceding a greater proportion of their premiums in this manner than unrelated parties. This concern is also raised in statements in the legislative history of the 2004 amendment to section 845(a).<sup>192</sup> If true, the IRS may be able to apply section 482 in a particular case to reallocate income and deductions between such related parties on the basis of the argument that an unrelated party would not have reinsured such a large proportion of its U.S. risks. However, it might be difficult for the IRS to show that the questioned transactions are not at arm's length. Although it is possible to characterize the issue as a transfer pricing issue, applying a set of definitive rules similar to the earnings stripping rules would probably have a more systematic effect on taxpayers than relying on transfer pricing principles.

#### Economic family doctrine

Another approach is suggested by a doctrine advanced by the government in several cases involving premium deductibility in captive insurance arrangements, the economic family doctrine. Under this doctrine, the insuring parent corporation and its domestic subsidiaries, and

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<sup>189</sup> It would also be important to address the effects of any such changes on U.S. trade agreements.

<sup>190</sup> As in the case of withholding taxes, it would be important to address the effects of any such changes on U.S. trade agreements.

<sup>191</sup> See discussion in the Background section of this document.

<sup>192</sup> See discussion in the Present law section of this document.

the wholly owned insurance subsidiary, though separate corporate entities, represent one economic family with the result that those who bear the ultimate economic burden of loss are the same persons who suffer the loss.<sup>193</sup> Although the economic family doctrine was not adopted by courts in the absence of any legislative rule imposing it, it may nevertheless represent an analysis under which related party reinsurance premiums could be addressed by statute. In taking such an approach, consideration could be given to the percentage of ownership of affiliates, by vote, value, and in terms of practical business control, that should constitute an economic family. Other aspects of the analysis would involve a determination of the percentages of affiliated and third-party reinsurance, respectively, that would cause premiums paid to a member of the economic family not to be deductible, and whether imposition of tax in the affiliate's jurisdiction of incorporation is relevant.

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<sup>193</sup> Rev. Rul. 77-316, 1977-2 C.B. 53, *obsoleted* by Rev. Rul. 2001-31, 2001-1 C.B. 1348. The Internal Revenue Service announced in Rev. Rul. 2001-31 that it would not raise the economic family theory in determining whether payments between related parties are deductible insurance premiums. The deductibility of premiums paid by an insurer for reinsurance of 90 percent of its business with a Bermuda affiliate was successfully challenged by the IRS in *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), *aff'd*, 640 F. 2d 1010 (9th Cir. 1981), *cert. denied*, 454 U.S. 965 (1981). However, in a number of subsequent cases involving related party insurance or reinsurance in parent-subsidiary or brother-sister corporate structures, courts did not adopt the economic family theory. See *Clougherty Packing Co. v. Commissioner*, 84 T.C. 948 (1985), *aff'd*, 811 F.2d 1297 (9th Cir 1986); *Humana Inc. v. Commissioner*, 88 T.C. 197 (1987), *aff'd, rev'd, and rem'd*, 881 F.2d 247 (6th Cir. 1989); *Malone & Hyde v. Commissioner*, T.C.M. 1989-604, T.C.M. 1993-585, *rev'd*, 62 F.3d 835 (6th Cir. 1995); *Hospital Corp. of America v. Commissioner*, T.C.M. 1997-482 (1997); *Kidde Industries, Inc. v. U.S.*, 40 Fed. Cl. 42 (1997), *dismissed*, 194 F.3d 1330 (Fed. Cir. 1999).

## **B. Issues and Analysis Relating to the Unrelated Business Income Tax and Debt-Financed Income**

### **Use of offshore corporations to “block” unrelated business income tax**

As discussed previously, the Code imposes a tax (the unrelated business income tax, or “UBIT”), at ordinary corporate rates, on an exempt organization’s unrelated business taxable income (“UBTI”). An organization’s UBTI includes the organization’s unrelated debt-financed income.

In the absence of planning, exempt organizations that invest in an investment partnership may have adverse tax consequences from the partnership’s receipt (directly or through one or more partnerships) of certain items of income related to the partnership’s portfolio investments. However, the IRS has concluded in a series of private letter rulings that, where UBTI-producing assets are owned by a corporation, or an entity that elects to be treated as a corporation for Federal tax purposes, and an exempt organization invests directly or indirectly in such corporation or entity, the exempt organization generally will not recognize UBTI as a result of the investment. Under such circumstances, the separate existence of the corporation or entity generally will be respected, and the exempt organization generally will be treated as receiving only passive dividend income that is excluded from the organization’s UBTI. When such entities are interposed between an exempt organization investor and assets that would give rise to UBTI if owned by the exempt organization directly (or through a pass-through entity) they commonly are referred to as “UBIT blockers” or “blocker corporations.” Because the assets of hedge funds and private equity funds frequently are debt-financed, exempt organizations that invest in such funds often use UBIT blockers to avoid attribution of the funds’ acquisition indebtedness to the exempt organization and thereby to avoid recognition of UBTI.

UBIT blockers may be established offshore in tax haven jurisdictions to avoid or minimize tax at the blocker corporation level.<sup>194</sup> Most hedge funds and other alternative investment vehicles organize their affairs to comply with the securities trading “safe harbor” of section 864(b), so that little if any of the income is subject to U.S. net income tax in the hands of an offshore blocker corporation or any other foreign investor. An offshore blocker corporation in turn may be a PFIC for U.S. tax purposes, but income from a PFIC is not UBTI in the hands of a U.S. tax-exempt organization.<sup>195</sup>

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<sup>194</sup> There may be methods by which an exempt organization can “block” UBIT without investing through an offshore corporation and without incurring an entity-level tax, such as by making certain investments in REITs.

<sup>195</sup> If a blocker corporation were subject to U.S. corporate tax on income that would be UBTI if derived directly by a tax-exempt organization, the use of the blocker corporation may not reduce the total U.S. tax liability attributable to an investment. In that case, avoidance of the administrative burdens of complying with the UBTI rules and similar concerns, rather than reduction of total tax liability, may be a principal reason for use of a blocker corporation. See Robert D. Blashek & Scot A. McLean, *Investments in ‘Pass-Through’ Portfolio Companies by Private Equity Partnerships: Tax Strategies and Structuring*, 704 Practising Law Institute/Tax 689 (June 2006), p. 789.

Some argue that the use of offshore UBIT blockers creates inequities, because it allows for avoidance of UBIT by sophisticated organizations that can afford complex tax planning, whereas less sophisticated organizations that wish to invest in debt-financed or other UBTI-producing property must pay tax or not make the investment. Others argue that the ability to block UBIT by investing through blocker corporations established in tax haven jurisdictions results in the investment of capital offshore rather than domestically, and that this is undesirable. However, others argue that the use of offshore UBIT blockers does not have this result, because the underlying investment assets frequently are located in the United States.

Some argue that recognition of the separate legal existence of a corporate entity, even if established offshore, is a bedrock principle of U.S. tax law and should not be modified in the UBIT context. In the context of debt-financed assets, some also argue that where an exempt organization investor is not liable for acquisition indebtedness incurred by a blocker corporation (or an entity in which the blocker corporation holds an interest), such indebtedness should not be attributed to the exempt organization and thereby give rise to UBTI.

### **The unrelated debt-financed income rules**

The unrelated debt-financed income rules were expanded in 1969 to tax not only certain rents from debt-financed acquisitions in real property, but to tax in addition other debt-financed income such as interest, dividends, other rents, royalties, and certain gains and losses from any type of property. Some argue that, in enacting the broader debt-financed income rules in 1969, the Congress appeared to have been reacting principally to certain specific sale-leaseback arrangements involving the sale of assets by taxable persons to exempt organizations that were perceived to be abusive. They argue, for example, that the rules were an overbroad reaction to a specific problem, do not have a sound policy basis, and either should be repealed or substantially modified.<sup>196</sup> Others, however, argue that in enacting the debt-financed income rules, the Congress believed that the rules were necessary to prevent exempt organizations from using debt to leverage tax-exempt status.<sup>197</sup> For example, in testimony before the Senate Finance Committee in 1982, the Treasury Department, opposing a proposed exception to the unrelated debt-financed income rules, argued that the rules help prevent unintended tax benefits from tax-exempt status, including the shifting of benefits of exempt status to taxable parties.<sup>198</sup>

Another argument sometimes made in opposition to the debt-financed income rules is that the rules may in certain cases treat similar transactions differently, because an exempt organization may be able to replicate the economic consequences of acquisition indebtedness

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<sup>196</sup> See, e.g., Suzanne Ross McDowell, *Taxation of Unrelated Debt-Financed Income*, *The Exempt Organization Tax Review* (Vol. 34, No. 2), November 2001, at 210.

<sup>197</sup> H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

<sup>198</sup> Statement of William McKee, Tax Legislative Counsel, Department of the Treasury, *1981-92 Miscellaneous Tax Bills, XVI: Hearing on S. 2498 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee*, 97<sup>th</sup> Cong., 2d Sess. 54 (1982).

through a derivative investment that would not be treated as debt under the debt-financed income rules. As a result, the rules have been described as creating “‘traps for the unwary’ and opportunities for the well-advised.”<sup>199</sup>

### **The real property exception to the unrelated debt-financed income rules**

The unrelated debt-financed income rules include an exception for certain investments in real property by qualified organizations.

When the real estate exception first was enacted for qualified pension trusts in 1980, the Treasury Department did not oppose its enactment. Consistent with Congress’ rationale for limiting the real property exception to pension funds, the Treasury Department testified that an exception limited to pension funds could be justified, because exempting investment income was a primary reason for such funds’ exemption from income tax.<sup>200</sup> However, the Treasury Department opposed the subsequent extension of the real property exception to schools. The Treasury Department argued, for example, that providing an exception for investments by section 501(c)(3) schools would result in permanent exemption from income, whereas the exception for investments by pension funds results only in deferral of income recognition, because the income generally will be taxed to individuals upon receipt of distributions. In addition, the Treasury Department argued that there is no basis for providing an exception for schools but not for other section 501(c)(3) organizations, and likened such an exception to “piecemeal” repeal of the unrelated debt-financed income rules.<sup>201</sup> Finally, the Treasury Department cautioned that expansion of the real property exception could lead others to seek exceptions for investments in other types of property.<sup>202</sup> Commentators similarly have argued that there is no principled basis for providing an exception for investments in real property by section 501(c)(3) schools, while not providing such an exception for investments by other charitable organizations or for investments in other types of property.

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<sup>199</sup> McDowell, *supra*, at 212 (arguing that well-advised organizations oftentimes can structure leveraged investments that are not treated as debt-financed under the unrelated debt-financed income rules, but which have similar economic consequences to investments that, if made, would be treated as debt-financed).

<sup>200</sup> Statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury, *Five Miscellaneous Tax Bills: Hearings on S. 650 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee*, 96<sup>th</sup> Cong., 2d Sess. 298 (1980).

<sup>201</sup> Statement of William McKee, Tax Legislative Counsel, Department of the Treasury, *1981-92 Miscellaneous Tax Bills, XVI: Hearing on S. 2498 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee*, 97<sup>th</sup> Cong., 2d Sess. 54-55 (1982).

<sup>202</sup> Statement of Robert G. Woodward, Acting Tax Legislative Counsel, Department of the Treasury, *Hearings before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee*, 98<sup>th</sup> Cong., 1st Sess. 88-89 (1983).

Some also argue that the mechanics of the real property exception, in particular the fractions rule, are overly complex and impose unfair burdens on qualified organizations.<sup>203</sup> They argue, for example, that the requirement that the fractions rule be satisfied hypothetically on a prospective basis for future years of a partnership creates hardships in structuring what ordinarily would be routine real-estate investment transactions. Others, however, argue that qualified organizations today regularly structure investments that satisfy the fractions rule, and that the rule is necessary to prevent the inappropriate shifting of benefits from tax-exempt partners to taxable partners.

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<sup>203</sup> See William H. Weigel, *Unrelated Debt-Financed Income: A Retrospective (and a Modest Proposal)*, 50 *Tax Lawyer* 3 (1996-1997), at 632-635; see generally Arthur A. Feder & Joel Scharfstein, *Leveraged Investment in Real Property through Partnerships by Tax Exempt Organizations after the Revenue Act of 1987 – A Lesson in How the Legislative Process Should Not Work*, 42 *Tax Lawyer* 55 (Fall 1988).

## C. Issues and Analysis Relating to Nonqualified Deferred Compensation

### **In general**

Nonqualified deferred compensation is a common form of executive compensation. From the executive's perspective, the desire to defer taxes is generally the key motivating factor behind deferred compensation. Individuals may want to defer compensation to a future date because they believe that their rate of tax will be lower in the future than it is currently, thus resulting in payment of lower taxes than if the compensation had been received currently. To the extent that the deferral is credited with earnings, an additional advantage is the pre-tax compounding of such earnings. Individuals may defer compensation in order to provide a future income stream in retirement. ERISA's exemptions for nonqualified deferred compensation arrangements allow great flexibility in designing plans and individual arrangements.

As discussed, fund managers' interests may be structured as a contractual arrangement to pay compensation based on the profits of the fund (as opposed to an ownership interest in the fund). In such cases, the compensation may be deferred. Questions have been raised as to whether deferral of the compensation for management services is appropriate in the case of an offshore structure.<sup>204</sup>

### **Magnitude of deferrals**

Some argue that nonqualified deferred compensation is merely an avoidance of current income taxation and that any amount of deferral should be prohibited. Others point to the amount of compensation that is deferred in certain cases as raising tax or social policy concerns. Much attention has been focused on the large amounts of compensation deferred offshore. While many would view this as inappropriate, it may be argued that the deferral opportunities for fund managers offshore are no different than for other individuals or entities providing services, such as key corporate executives. Nonqualified deferred compensation is a common compensation arrangement for executives in all types of industries, regardless of whether the executive's employer is a U.S. or foreign entity.

As discussed above, neither the Code nor ERISA limit the amount of nonqualified deferred compensation. Because the service recipient (e.g., the employer or the investment fund) is denied a deduction for deferred compensation until the service provider (e.g., the employee or the fund manager) includes the compensation in income, in the case of a payor that is a U.S. taxpayer, there is often said to be a tension between the interests of the service provider and the service recipient that will result in an appropriate limit on deferred compensation. It is argued that this tension is not present in the case of offshore deferrals by hedge fund managers because the deferral agreement is between the fund manager and a foreign feeder corporation. The

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<sup>204</sup> See Jenny Anderson, "Managers Use Hedge Funds as Big I.R.A.'s," *New York Times*, April 17, 2007. See also section 536 of H.R. 1591 (An act making emergency supplemental appropriations for the fiscal year ending September 30, 2007, and for other purposes), as passed by the Senate, which contains a provision that would generally impose a \$1 million annual limit on nonqualified deferred compensation.

foreign feeder corporation is an entity that is not a U.S. taxpayer and the shareholders of which are either U.S. tax-exempt entities or are not U.S. taxpayers. As a result, the foreign feeder corporation and its shareholders are indifferent to the availability of a U.S. tax deduction for compensation. In contrast, deferral agreements are not typically entered into between the fund manager and the domestic feeder fund or the master investment fund. This is because U.S. taxpayers, directly or indirectly, hold interests in these entities, which typically are organized as partnerships, and these U.S. taxpayers are sensitive to the deduction timing issue.

Many believe that it is inappropriate to allow deferral of income in cases in which the deferral of the payor's deduction has no consequence (e.g., in the case of an entity that pays no U.S. tax). Present law recognizes that different rules may be appropriate when the payer is not a taxable entity. For example, the Code provides more restrictive rules for deferred compensation plans of governmental and tax-exempt employers than for taxable entities.<sup>205</sup> Some believe that allowing deferral of income is only appropriate when a corresponding deduction is also deferred. Of course, this issue is not unique to hedge funds or other investment management firms. A U.S. citizen working for a foreign employer may be permitted to defer compensation even though the foreign entity does not forego or postpone a deduction under its applicable tax laws.

Some believe that the theoretical tension between the employer's interest in a current tax deduction and the employee's interest in deferring tax has little, if any, effect on the amount of compensation deferred by executives. It is pointed out that the tension in the corporate context is often more theoretical than real, because many corporations have net operating losses and do not currently pay taxes, there may be a business purpose to allow the deferral (such as the desire to provide a retention incentive), and because the employer may wish to accommodate the desire of the employee for deferral in order to attract and retain qualified executives.<sup>206</sup>

As previously discussed, the rules under section 409A provide requirements as to elections and permissible distribution events. Section 409A was enacted to address concerns relating to inappropriate access of executives to amounts deferred and does not limit the amount of compensation that can be deferred. Some believe that deferrals under an offshore hedge fund arrangement are not inappropriate as long as the deferrals satisfy the requirements of section 409A. Others believe that section 409A generally should be broadened to restrict the amount of compensation that can be deferred. They believe that a limit on the amount that can be deferred is appropriate given the relatively low limits that are imposed on amounts deferred under a qualified retirement plan. For example, rank and file employees who participate in a section 401(k) plan can defer no more than \$15,500 in 2007, while executives in a nonqualified deferred compensation plan can defer an unlimited amount. Some also believe that additional restrictions on nonqualified deferred compensation are appropriate as such plans are free of most of the restrictions that apply to qualified employer plans (e.g., nondiscrimination rules).

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<sup>205</sup> Sec. 457(f).

<sup>206</sup> Additionally, in the case of a publicly traded corporation, the section 162(m) limit on the deductibility of remuneration paid to a covered employee provides an incentive for the corporation and covered employee to structure compensation in excess of the limit as deferred compensation since such compensation is not subject to the deduction limit.

While some argue that allowing unlimited amounts of deferral through an offshore entity is inappropriate, it may be possible that the tax benefits that are achieved by deferring compensation paid by an offshore entity can also be achieved through other structures. For example, a foreign corporation could grant the fund managers options in the foreign corporation which could defer recognition of ordinary income until the options are exercised. However, if the corporation is a passive foreign investment company, the tax advantages of deferral may be negated.<sup>207</sup>

### **Compliance issues/reporting**

Some have raised the issue that there may be compliance issues under section 409A in the fund manager context, especially if there are foreign payors of nonqualified deferred compensation. On the other hand, the significant consequences of failing to comply with section 409A (current income inclusion, plus an additional 20-percent tax, plus interest) may provide sufficient incentive for compliance, at least if there is a belief that detection of noncompliance by the IRS is reasonably likely.

Present law requires annual reporting of amounts deferred under a nonqualified deferred compensation plan even if amounts are not currently includible in income. The implementation of this requirement has been delayed by the Treasury Department. Final regulations issued by the Department of Treasury do not address the reporting requirements applicable to service recipients providing nonqualified deferred compensation covered by section 409A. Under Notice 2006-100, 2006-51 I.R.B. 1109, the IRS announced that an employer (or other payor) is not required for 2005 and 2006 to report amounts deferred during the year under a nonqualified deferred compensation plan subject to section 409A. Many believe that requiring reporting of amounts deferred to the IRS, even if the taxpayer takes the position that such amounts are not currently includible in income, could provide the IRS greater information regarding such arrangements. In most cases, the IRS does not have any information reported to it regarding amounts deferred, and therefore, no indication that a particular arrangement should be examined.<sup>208</sup> This argument is present in the fund manager context as the IRS has little information as to such arrangements. Many believe that the reporting requirement under present law could provide the IRS with information necessary to better examine such arrangements and that the Treasury Department should require compliance with the statutory requirement.

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<sup>207</sup> Proposed Treasury regulations under section 1291 provide that (1) an option to acquire stock in a passive foreign investment company is treated as stock for purposes of applying the excess distribution rules to the disposition of the option and (2) the holding period of a share of passive foreign investment company stock acquired by the exercise of an option includes the period the option was held. Section 1291(a)(2) provides that gain recognized on the sale of stock of a passive foreign investment company is treated as an excess distribution. Accordingly, under the tax-plus-interest rules of section 1291 and the accompanying proposed regulations, the sale of an option or the exercise of an option followed by the immediate sale of the underlying stock generally would trigger an interest charge computed based on the taxpayer's option and stock holding period.

<sup>208</sup> Securities and Exchange Commission regulations require disclosure in public filings of certain information related to nonqualified deferred compensation. *See e.g.*, 17 C.F.R. § 229.402(i).

## **Offshore trusts**

As previously discussed, section 409A provides for income inclusion in the case that assets restricted to deferred compensation are set aside in an offshore trust or similar arrangement. This provision was specifically intended to apply to foreign trusts and arrangements that effectively shield from the claims of general creditors any assets intended to satisfy nonqualified deferred compensation arrangements. This provision would not be triggered in the case of an offshore nonqualified deferred compensation arrangement so long as the amounts deferred are not set aside in an offshore trust or similar arrangement.

Some believe that a fund manager's offshore deferred compensation should be treated as an arrangement similar to an offshore trust, even if the arrangement is not technically funded by a trust. Others believe that treatment as an offshore trust is not appropriate merely because the payor of the deferred compensation is a foreign person. Such persons argue that additional factors are necessary for offshore trust treatment, such as whether the creditors of the offshore fund are effectively shielded from access to the fund's assets in the event of default or whether the creditors of the fund are limited primarily to the fund's investors.