Taxing issues

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A recent United States tax law amendment requires substantial changes to be made to non-US trusts and similar arrangements, commonly known as "Rabbi Trusts," intended to fund or otherwise secure deferred compensation payable to US citizens, green card holders and residents. Such deferred compensation Rabbi trust arrangements and their assets soon will have to be located within the US to avoid income tax (at rates up to 35%), a penalty of 20%, and an additional interest charge on all vested trust assets. Due to these significant changes, if you are serving as trustee, investment adviser or custodian under these types of arrangements, we urge you to contact a US international tax specialist to determine what steps are required to avoid the US beneficiary being subject to these potentially confiscatory taxes.

Background

The American Jobs Creation Act of 2004 ("ACJA") enacted new Section 409A of the US Internal Revenue Code. Under Section 409A(b), any trust or other arrangement designed to pay deferred compensation to a US person (and any assets held in such trust or arrangement) must be located within the US. Failure to locate the trust and its assets within the US results in (i) the value of the assets being includible in the US person's income, (ii) an additional tax of 20% on the amount includible in income, and (iii) an interest charge to reflect the delay between the time the US person deferred the payment and the time the payment is deemed includible under Section 409A. Under the effective date rule contained in AJCA, such trusts and other arrangements which were already in existence before January 1, 2005 were grandfathered and such trusts or arrangements and their assets could continue to be located outside the US without triggering income taxation and penalties under Section 409A.

The Gulf Opportunity Zone Act ("GOZA"), signed into law December 21, 2005, eliminates the grandfathering for pre-2005 deferred compensation trust arrangements. Any such trusts or other arrangements located outside the US or with assets outside of the US are therefore in violation of Section 409A as of January 1, 2005. Due to the complexity of the issues involved, on March 21st, the US Treasury Department issued guidance providing for a transition period until December 31, 2007 for non-compliant trusts and arrangements to conform to the Section 409A requirements without triggering tax and penalties. Until the Treasury Department issues further guidance, new plans are permitted to rely upon "a reasonable, good faith interpretation of Section 409A(b) to determine whether the use of a trust or other arrangement causes an amount to be included in income under Section 409A(b)."

We are sensitive to the reality that a trustee or investment adviser with an established a relationship with an employer and its employees can add significant value with regard to existing relationships and management of trust assets. We also are aware that a trustee or investment adviser may be holding funds on behalf of a number of employees, not all of whom are US persons. Moreover, we recognize there may be advantages to having the asset pool managed by a single adviser. Nevertheless, we believe it is critical that certain changes must be implemented before the amnesty period expires.

Fortunately, we have experience creating structures in which the existing trustee maintains responsibility for investment management while the trusteeship and custody are assumed in part by a US person. While there cannot be certainty until the Treasury Department issues its guidance on how to "locate" a trust or other arrangement together with its assets within the US, we feel confident that proper structuring would result in the trust complying with Section 409A(b) while responsibility for investment management and control remains with the existing non-US trustee and investment adviser.

In our experience, modifying a trust or arrangement so it is "located" within the United States is a complex and time consuming process. Many US banks and trust companies are unable or unwilling to accept a trusteeship unless they have control over investment management decisions. Some are hesitant to act on behalf of employers or to delegate to investment managers who are organized or operate in non-US jurisdictions. Others will only do so if there are restrictions on the nature of the assets to be held in the trust.

In any case, it generally takes a substantial period of time to negotiate the terms of the trust documents and for the US trustee to perform its due diligence and know your customer reviews. Waiting periods of 6 months or more are not uncommon. One administrator for a major US bank confided to us recently that the last time they accepted a Rabbi trust for an employee who worked for a non-US employer at a non-US location, the project required 10 months to complete. Even if you are able to find a US institution willing to take on trusteeship of your client's deferred compensation trust, there is no guarantee that you will be able to restructure the arrangement prior to the expiration of the amnesty period.

We are in a position to help you move rapidly to relocate existing trusts into the US. We already have communicated with several US financial institutions who are willing to accept these trusteeships and delegate investment management to a non-US manager. We have negotiated a form of trust agreement under which they are willing to serve as directed trustee. Importantly, we have already explored the parameters under which they will, and will not, agree to act.

If you are currently serving as trustee of a trust or as investment adviser or custodian of assets designed to pay deferred compensation to a US person, please contact us to discuss what must be done to bring these arrangements into compliance with Section 409A. Given the time it takes to implement these transactions, it is not too soon to begin.

Authors

Edward A. Renn

PARTNER | NEW YORK, NEW HAVEN, GREENWICH

Private client and tax

+1 203 974 0343

edward.renn@withersworldwide.com

Richard S. Levine

SPECIAL COUNSEL | NEW YORK, NEW HAVEN

Private client and tax

+1 203 974 0317

richard.levine@withersworldwide.com

Jay Krause

PARTNER | LONDON

Private client and tax

+44 20 7597 6350

jay.krause@withersworldwide.com