

## Part III – Administrative, Procedural, and Miscellaneous

### Offshore Deferred Compensation Arrangements

#### Notice 2003-22

The Internal Revenue Service and the Treasury Department have become aware of a type of arrangement, described below, that is being promoted to and used by taxpayers for the purpose of avoiding or evading federal income and employment taxes. This notice alerts taxpayers and their representatives that the tax benefits purportedly generated by these arrangements are not allowable for federal income or employment tax purposes. This notice also alerts taxpayers, their representatives, and promoters of these arrangements of certain responsibilities that may arise from participating in or promoting these arrangements.

#### FACTS

In general, the arrangement involves a series of steps involving domestic and foreign parties. First, Taxpayer, an individual, purports to terminate Taxpayer's existing employment relationship with a domestic corporation ("Service Recipient Corporation") that may be owned, either directly or indirectly, in whole or in part by Taxpayer. Taxpayer then purports to enter into an employment relationship with a foreign corporation ("Foreign Leasing Corporation") that is incorporated and managed in a country with which the United States has an income tax convention. Foreign Leasing Corporation purports to lease the right to Taxpayer's services in the United States to a domestic corporation ("Domestic Leasing Corporation"). Domestic Leasing Corporation, in turn, purports to lease Taxpayer's services to Service Recipient Corporation.

Before entering into the arrangement, Taxpayer has little or no business relationship either with Foreign Leasing Corporation or with Domestic Leasing Corporation. After entering into the arrangement, Taxpayer continues to provide substantially the same services for Service Recipient Corporation that Taxpayer provided before entering into the arrangement, and, thus, the interposition of Foreign Leasing Corporation and Domestic Leasing Corporation has no significant effect on Taxpayer's performance of services for Service Recipient Corporation.

Service Recipient Corporation makes payments to Domestic Leasing Corporation for Taxpayer's services. Domestic Leasing Corporation makes payments to Taxpayer for Taxpayer's services in an amount substantially less than the amount paid to Domestic Leasing Corporation by Service Recipient Corporation. After deducting a fee for its participation in the arrangement, Domestic Leasing Corporation remits to Foreign Leasing Corporation, in return for Taxpayer's services, the remainder of the amount paid to Domestic Leasing Corporation by Service Recipient Corporation.

Foreign Leasing Corporation deducts a fee from the amount paid by Domestic Leasing Corporation and typically credits the remainder to a notional account maintained on behalf of Taxpayer. In certain cases, Foreign Leasing Corporation transfers the remainder to a trust ("Trust") for the benefit of Taxpayer. Although the assets of Trust may be nominally subject to the claims of Foreign Leasing Corporation's creditors, it is typically difficult or impossible for creditors of Foreign Leasing Corporation, Domestic

Leasing Corporation, or Service Recipient Corporation to reach the assets of Trust in the event of insolvency or bankruptcy of any of these entities.

The arrangement is often designed to provide Taxpayer, either directly or indirectly, with explicit or implicit control over the amounts held on Taxpayer's behalf by Foreign Leasing Corporation or Trust. For example, the arrangement may permit or require Foreign Leasing Corporation to provide Taxpayer with a device, such as a credit or debit card, for paying personal, business, or professional expenses out of such amounts. As another example, the arrangement may permit Taxpayer to submit bills and receipts for payment or reimbursement from such amounts or to borrow from such amounts.

Taxpayer takes the reporting position that only the compensation actually paid to Taxpayer by Domestic Leasing Corporation is currently includible in Taxpayer's gross income and that amounts held by Foreign Leasing Corporation or Trust on Taxpayer's behalf are not currently includible in Taxpayer's gross income.

Service Recipient Corporation takes the reporting position that the entire amount paid to Domestic Leasing Corporation in return for Taxpayer's services is currently deductible as a trade or business expense under § 162 of the Internal Revenue Code. Service Recipient Corporation does not report any amount attributable thereto or withhold or pay any amount therefrom for federal tax purposes.

Domestic Leasing Corporation takes the reporting position that both the compensation paid to Taxpayer and the amount paid to Foreign Leasing Corporation are currently deductible as a trade or business expense. Domestic Leasing Corporation does not treat the amount paid to Foreign Leasing Corporation as compensation to Taxpayer and, therefore, does not report any amount attributable thereto or withhold or pay any amount therefrom for federal tax purposes.

Foreign Leasing Corporation takes the position that it is a resident of a country with which the United States has an income tax convention, and that it is entitled to all of the benefits afforded under that convention. Foreign Leasing Corporation also takes the position that, pursuant to the convention, no portion of the amount paid to it by Domestic Leasing Corporation is subject to income tax by the United States because such amount is business profits which are not attributable to a permanent establishment in the United States.

The structure of the arrangement may vary without altering the applicability of this notice to the arrangement. For example, the applicability of this notice is not dependent upon Taxpayer owning Service Recipient Corporation, or Service Recipient Corporation being the same taxpayer before and after Taxpayer enters into the arrangement. Similarly, the applicability of this notice is not dependent upon Domestic Leasing Corporation or Foreign Leasing Corporation existing before Taxpayer enters into the arrangement. In addition, the applicability of this notice to the arrangement is not affected by replacing Domestic Leasing Corporation, Foreign Leasing Corporation, or Service Recipient Corporation (or two or more of those corporations) with one or more non-corporate entities. Likewise, the applicability of this notice to the arrangement is not affected by replacing Trust with another person or persons, or by involving one or more other corporations or non-corporate entities. These and similar variations are within the scope of this notice. Moreover, the means (if any) by which Taxpayer has control over the amount held by Foreign Leasing Corporation or Trust on Taxpayer's behalf are not limited to the means described in this notice.

## ANALYSIS

The arrangement described in this notice involves a series of steps, some or all of which do not reflect the underlying economics of the arrangement, and has been designed to circumvent longstanding legal principles to enable Taxpayer and Service Recipient Corporation to avoid or evade income and employment taxes. Taxpayers who participate in the arrangement may believe they can achieve its purpose or intended result by relying on various documents and agreements, which purportedly create binding and legally enforceable obligations among the parties to the arrangement. The Internal Revenue Service intends to challenge the purported tax benefits claimed for this arrangement on a number of

grounds, including, but not limited to, the nature and substance of the arrangement and of the documents and agreements used to facilitate it.

In challenging the purported tax benefits, the Service will, in appropriate cases, assert that Taxpayer's employment by Foreign Leasing Corporation and the additional steps by which Taxpayer's services are leased back to Service Recipient Corporation are disregarded for federal tax purposes. Thus, the Service will assert that Taxpayer remains the employee of Service Recipient Corporation and that amounts paid by Service Recipient Corporation to Domestic Leasing Corporation either (1) are currently includible in Taxpayer's gross income as compensation for services provided to Service Recipient Corporation or (2) are not currently deductible by Service Recipient Corporation.

More specifically, with regard to the tax benefits claimed by Taxpayer and irrespective of whether the Service asserts that the leasing arrangement should be disregarded for tax purposes, the Service may assert, in appropriate cases, that amounts paid to Domestic Leasing Corporation by Service Recipient Corporation have been actually or constructively received by Taxpayer. The Service may assert, in addition or in the alternative, that such amounts are currently includible in Taxpayer's gross income under § 83(a), the economic benefit doctrine, the cash equivalency doctrine, or the assignment of income doctrine, or that such amounts are constructive dividends to Taxpayer.

With regard to Service Recipient Corporation, the Service may assert that the amount paid to Domestic Leasing Corporation, less the amount Domestic Leasing Corporation pays currently to Taxpayer, is nonqualified deferred compensation, the deductibility of which is governed by § 404(a)(5) and which is subject to FICA tax under § 3121(v)(2), or property transferred to Taxpayer in connection with the performance of services, the deductibility of which is governed by § 83(h) and which is subject to FICA tax under § 3121(a) or 3121(v)(2). The Service also may disallow the deductibility of such amount as (1) not being an ordinary and necessary business expense under § 162 or (2) being a nondeductible constructive dividend to Taxpayer.

Finally, the Service also may challenge attempts to apply a tax convention between the United States and a foreign country to the arrangement in a manner that is inconsistent with the way the arrangement is characterized for United States tax purposes.

Arrangements that are the same as, or substantially similar to, the arrangement ("Offshore Deferred Compensation Arrangement") described in this notice are, with respect to Taxpayer, Service Recipient Corporation, and Domestic Leasing Corporation, identified as "listed transactions" for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. Further, it should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2), arrangements that are the same as, or substantially similar to, an Offshore Deferred Compensation Arrangement may already be subject to the disclosure requirements of § 6011, the tax shelter registration requirements of § 6111, or the list maintenance requirements of § 6112 (§§ 1.6011-4, 301.6111-1T, 301.6111-2, and 301.6112-1).

Persons who are required to satisfy the registration requirement of § 6111 with respect to the arrangement described in this notice and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list-keeping requirement of § 6112 with respect to the transaction and who fail to do so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this arrangement or substantially similar arrangements, or, as applicable, on persons who participate in the promotion or reporting of this arrangement or substantially similar arrangements, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701. In addition to other penalties, any person who willfully attempts to evade or defeat tax by means of the arrangement

described in this notice or substantially similar arrangements, or who willfully counsels or advises such evasion or defeat, may be guilty of a criminal offense under §§ 7201, 7203, 7206, or 7212(a) or other provisions of federal law.

The Service cautioned taxpayers against the arrangement described in this notice in a recent outreach project. Although that particular outreach project was directed toward medical professionals, the applicability of this notice is not dependent upon Taxpayer being a medical professional. Taxpayers can obtain copies of the Service's alert on the IRS Web site at [www.irs.gov](http://www.irs.gov) - search term "employee leasing."

Taxpayers who have participated or who are currently participating in the arrangement described in this notice are encouraged to apply to participate in the Offshore Voluntary Compliance Initiative described in Rev. Proc. 2003-11, 2003-4 I.R.B. 311.

The principal author of this notice is Ken Griffin of the office of Division Counsel / Associate Chief Counsel, Tax Exempt and Government Entities. For further information regarding this revenue ruling contact Mr. Griffin at (202) 622-6030 (not a toll-free call).