

Finance Memorandum

Recognition and Allocation of Deferred Income from a Non-Qualified Deferred Compensation Plan

Introduction

The Unincorporated Business Tax (the “UBT”) is a business level tax that applies to the net income of unincorporated businesses wholly or partly carried on within New York City (the “City”)¹. Limited partnerships, partnerships, limited liability companies, sole proprietorships, and other unincorporated businesses are subject to the UBT. The UBT is a business tax that is separate from the City’s Personal Income Tax.

For purposes of this Memorandum, the term “partnership” refers to any entity that constitutes a partnership for federal income tax purposes. New York City follows federal “check the box” entity classification rules to determine whether an entity is a partnership².

This Memorandum addresses the recognition of income that a taxpayer has deferred pursuant to section 409A of the Internal Revenue Code of 1986, as amended (the “IRC”), and explains how the taxpayer should report the income for UBT purposes. It concludes that:

- (i) a taxpayer must recognize the full amount of its deferred income as compensation for services under the UBT in the same tax year that it recognizes the income for federal income tax purposes;
- (ii) the taxpayer must use the law and rules that apply in the year of recognition to compute its Business Allocation Percentage (the “BAP”); and
- (iii) the taxpayer’s activities that generated the right to its deferred income determine connection to the City and place of performance for purposes of the payroll and gross income factors attributable to that income in its BAP.

The same framework applies for the City’s Business Corporation Tax and General Corporation Tax.

Law & Analysis

Background: Income Recognition for Federal and UBT Purposes

Federal Income Tax. A taxpayer’s overall method of accounting generally determines when he, she or it recognizes items of income for federal income tax purposes, subject to specific rules for special methods. The cash and accrual methods of accounting are the most common. The cash method requires recognition when the taxpayer receives the payment, while the accrual method requires that income be recognized at the time when all events have occurred that fix the right to receive the income and the amount is determinable with reasonable accuracy.³ Most businesses operate under the accrual method, but a partnership that does not have a C corporation as a partner generally may use the cash method.

UBT. The taxable income of an unincorporated business is the excess of its “unincorporated business gross income” over its “unincorporated business deductions”, allocated to the City, minus certain deductions not subject to allocation and statutory exemptions.⁴

Federal gross income and deductions are the starting points for unincorporated business gross income and unincorporated business deductions.⁵ Unincorporated business gross income is the sum of the business’s items of income and gain includible in federal gross income for the tax year, with City specific modifications.⁶ Unincorporated business deductions are the items of loss and deduction directly connected with or incurred in the conduct of the taxpayer’s business, which are allowable for federal income tax purposes, with City specific modifications.⁷

¹Ad. Code § 11-503.

²See, Ad. Code §§ 11-126, 11-602.1, 11-652(1) and (13), and Finance Memorandum 99-1, Federal Check-the-Box Rules New York City Tax Implications (October 21, 1999).

³Treas. Reg. §1.451-1(a).

⁴Ad. Code § 11-505.

⁵Ad. Code §§ 11-506, 11-507.

⁶Ad. Code § 11-506(a)(1).

⁷Ad. Code. § 11-507

Under this framework, a taxpayer's method of accounting for federal income tax purposes will generally control the timing of its income and deductions for the UBT. However, UBT imposes unique characterizations on income after a taxpayer recognizes it, and the taxpayer must attribute its deductions among the separately characterized amounts.

In general, unincorporated business entire net income is business income, except to the extent it arises from investment capital.⁸ Some activities are non-taxable under the UBT entirely because they are deemed not to be an unincorporated business, such as "self-trading".⁹ Expenses reduce business income, except to the extent they are directly or indirectly attributable to investment income, or directly or indirectly attributable to non-taxable income or otherwise are not directly connected with or incurred in the conduct of the business, in which case they do not constitute unincorporated business deductions.¹⁰

Qualified and Non-Qualified Plans

Over time, taxpayers have attempted a wide variety of strategies to defer their recognition of income under both the cash and accrual methods of accounting, and, in response, several court-created doctrines, specifically the cash equivalency doctrine, the economic benefit doctrine, and the constructive receipt doctrine developed at the federal level. These judicial rules prevent taxpayers from purposefully deferring recognition of income when, for example, the funds are readily available or set aside in a trust. These doctrines led to IRC amendments that provide specific frameworks for deferred compensation plans.

Under the IRC, deferred compensation plans generally fall into two categories: qualified plans and nonqualified plans. Contributions to qualified plans result in deferred income for payees and current deductions for payors, subject to limits.¹¹ Contributions to nonqualified plans result in deferred income for payees and deferred deductions for payors. While nonqualified plans have a timing disadvantage for payors,¹² they can be more flexible than qualified plans. Section 409A of the IRC ("409A") provides the framework under which nonqualified deferred compensation plans ("NQPs") must operate to successfully defer income recognition. Investment managers and high-earning individuals often use non-qualified plans to defer income.

NQPs and the UBT

IRC § 409A. An NQP is any plan that allows a service provider to defer compensation and is not a qualified plan (or a vacation leave, sick leave, compensatory time, disability pay, or death benefit plan).¹³ Deferral occurs in any particular year if a service provider holds a legally binding right to compensation that is not actually or constructively received, and that is payable in a later tax year pursuant to the terms of the NQP.¹⁴ Accordingly, prior to payment, deferred compensation is a promise to pay, and cannot be an ownership interest in a financial or other tangible or intangible asset. 409A does not override the doctrine of constructive receipt or the rules governing transfers of property in connection with performance of services under section 83 of the IRC¹⁵. Upon payment, it is compensation for services and ordinary income.

The 409A requirements are numerous.¹⁶ In any year that an NQP fails to meet the requirements of 409A, or is not operated in accordance with those requirements, the deferral ends. The taxpayer must then include all compensation deferred under the plan for the year and all preceding years in gross income, to the extent the compensation is not subject to a substantial risk of forfeiture and was not previously included in gross income.¹⁷

IRC § 457A. Prior to 2008, NQPs were popular with asset managers that had foreign or tax-exempt investors because the structure they used to solicit the foreign and tax-exempt funds could also be used to reinvest deferred fees without incurring U.S. tax on the compounding income. Section 457A of the IRC ("457A") arose to stop that strategy. It denies deferral if a nonqualified entity is paying the compensation.¹⁸ In that case, the service provider must include the compensation in gross income as soon as his, her or its rights

⁸Ad. Code. § 11-501(k).

⁹See Ad. Code. § 11-502 and 19 RCNY § 28-02 (describing activities that fall outside the definition of "unincorporated business," and do not generate business income).

¹⁰See Ad. Code. §§ 11-507, 11-501(i).

¹¹See IRC § 401.

¹²See IRC § 404.

¹³IRC § 409A(d)(1).

¹⁴Treas. Reg. § 1.409A-1(b).

¹⁵IRC 409A.

¹⁶The requirements under 409A can generally be grouped by reference to distributions, accelerations and elections and are summarized very basically in this footnote. Regarding distributions, the NQP must not allow for a distribution of funds earlier than specific, enumerated events, such as: a specific date or schedule in place at the time of deferral; separation from service, disability, or death of the service provider; the occurrence of an unforeseeable emergency; and certain changes of control. See IRC § 409A(a)(2). Regarding accelerations, the NQP must not allow for acceleration of any payments, except in specific situations allowed by the IRS. IRC § 409A(a)(3). Regarding elections, an NQP need not provide an election to defer income, but, if it does, the service provider must make the election prior to entering the tax year in which he, she or it will earn the compensation. IRC § 409A(a)(4). If a service provider becomes eligible to participate in a plan during a year, the election to participate must be made within 30 days of becoming eligible, and deferral will only apply to compensation earned after making the election. IRC § 409A(a)(4)(B)(ii). Subsequent elections can also be made to delay or change the form of the payment, but those elections may not take effect for 12 months, and, among other rules, the election to defer a scheduled payment must be made 12 months prior to the first scheduled payment. IRC § 409A(a)(4)(C).

¹⁷IRC § 409A(a)(1)(A), (B). An additional 20% tax and interest charge may apply as well.

¹⁸The definition of NQP is similar under Sections 457A and 409A but not co-extensive. In particular, Section 457A provides that deferred income includes a right to compensation based on equity appreciation in the service recipient. IRC § 457A(d)(3). The definition of substantial risk of forfeiture is also narrower under 457A because the only condition giving rise to a substantial risk is the future performance of substantial services, with an exception for compensation based on gain recognized on an investment asset. IRC § 457A(d)(1). If the right to compensation has vested, but the amount is not yet determinable, it must be included in gross income at the time it is determinable, but an additional tax equal to 20% of the amount of the income so included and interest at the underpayment rate plus 1 percentage point will apply. IRC § 457A(c).

are not subject to a substantial risk of forfeiture.¹⁹ Nonqualified entity is the key term and generally captures entities that are indifferent to the deferral.²⁰ While 457A applies to compensation attributable to services performed after December 31, 2008, it also limits deferral for compensation from services performed before that date, in which case the deferred income must be included in gross income in the later of the last year beginning before 2018 or the year in which it is no longer subject to substantial risk of forfeiture.²¹

UBT. Deferred income must be recognized for UBT purposes in the same tax year that it must be recognized for federal income tax purposes, including in the event of a plan failure under 409A or a deadline imposed by 457A. The Department of Finance ("DOF") may examine NQPs and deferral elections to determine whether they satisfy the requirements of 409A or 457A.

Characterization of Deferred Income

Deferred compensation, when paid to the taxpayer, is business income for UBT purposes, consistent with its federal character as ordinary income and status as an untaxed promise to pay compensation for services. Deferred compensation cannot qualify as income from investment capital or income from a self-trading activity because an untaxed promise to pay is not property or an underlying interest in assets that would give rise to investment capital or a self-trading activity (a vested property interest would have already been subject to tax).²² Once the compensation is paid in cash or in-kind, and taxed, it may be converted into property or an interest in assets that would give rise to investment capital or a self-trading activity, but the nature of deferral precludes any non-business character prior to recognition. This status also means that any increases or decreases in the amount due to the service provider, based on the use of the unpaid funds during the deferral period, are an increase or decrease, as applicable, in the amount of compensation the service recipient ultimately recognizes. Further, no matter how the unincorporated business shows deferred income as an asset on its balance sheet, the right to payment does not meet the definition of property for the purposes of the partial exemption from the UBT for self-trading.

Allocation of Deferred Income

Business income from an unincorporated business carried on both inside and outside of the City must be equitably allocated to the City, generally using a statutory business allocation percentage ("BAP").²³ The methods for allocating income and calculating the BAP, however, have not been static, and have changed in important ways from 2005 through 2018.

Accordingly, the law and methods that apply to allocation in the tax years that some taxpayers deferred significant amounts of income are different from the law and methods that apply when they recognize and report that income. In particular, books and records method of allocation is no longer applicable; the BAP has phased into a single factor formula based entirely on gross income instead of a three factor formula based on property, payroll and gross income; and the place of performance determines the source of gross income from services.²⁴

Because income is not taxable under the UBT until it is included in federal gross income, the deferred income does not incur the application of its allocation requirements until it is recognized, and the law and allocation methods that apply in the year of inclusion must be used to allocate the deferred income (consisting of the full amount recognized under the NQP in the applicable tax year). The method for allocating income from services in tax year 2006, for example, does not apply to income recognized in tax year 2017, even if some portion of it was earned and deferred under a valid NQP in 2006.

While the law applicable to deferred income may differ between the year of deferral and the year of inclusion, the activities that generated the right to the income enter into the allocation analysis in the gross income factor, and to the extent the taxpayer pays back-to-back deferred compensation, the payroll factor. The BAP factors should therefore be determined as follows when the taxpayer reports deferred income:

- **Property Percentage.** Unless a discretionary adjustment is appropriate, the taxpayer's real and tangible personal property in the inclusion year, but not earlier years, enter into the property percentage.²⁵ If the taxpayer has no applicable property, the factor does not enter into the formula.²⁶
- **Payroll Percentage.** Unless a discretionary adjustment is appropriate, the taxpayer's total personal service compensation in the inclusion year, but not earlier years, enters into the payroll percentage.²⁷ Some portion of the compensation might itself be deferred income, however, and relate to past services. In that circumstance, the services the current or former service providers performed for that compensation will determine whether it is connected to the taxpayer's business in the City. For example, if an employee elected to defer a portion of his or her compensation for services performed for the taxpayer's business in the City in

¹⁹IRC § 457A(a).

²⁰It includes any foreign corporation, unless substantially all of its income is effectively connected with a U.S. trade or business or is subject to comprehensive foreign tax, and any partnership, if substantially all of its income is allocated to either tax-exempt organizations or foreign persons, with respect to whom such income is not subject to a comprehensive foreign tax. IRC §457A(b).

²¹Pub. Law 110-343 § 801(d).

²²See, Ad. Code §§ 11-501(h) and (i), 11-502(c)(1)(A) and (c)(4)(B),(C)23Ad. Code § 11-508(c).

²³Ad. Code § 11-508(c).

²⁴Ad. Code § 11-508(b), (c) and (i), and 11-508(o)(3)(C).

²⁵The UBT states that a taxpayer should determine the property percentage by "dividing (A) the average of the value, at the beginning and end of the taxable year, of real and tangible personal property connected with the unincorporated business and located within the city, by (B) the average of the value, at the beginning and end of the taxable year, of all real and tangible personal property connected with the unincorporated business and located both within and without the city." Ad. Code § 11-508(c)(1).

²⁶19 RCNY § 28-07(d)(5)(ii).

²⁷The UBT states that a taxpayer should determine the payroll percentage by "dividing (A) the total wages, salaries and other personal service compensation paid or incurred during the taxable year to employees in connection with the unincorporated business carried on within the city, by (B) the total of all wages, salaries and other personal service compensation paid or incurred during the taxable year to employees in connection with the unincorporated business carried on both within and without the city." Ad. Code §11-508(c)(2).

2006, and the taxpayer paid him or her in 2017 pursuant to an NQP, the full amount of the taxpayer's payment would constitute personal service compensation paid or incurred in connection with business carried on within the City for purposes of its 2017 payroll percentage.

- **Gross Income Percentage.** Unless a discretionary adjustment is appropriate, the taxpayer's total gross income in the inclusion year, but not earlier years, enters into the gross income percentage.²⁸ The factor therefore includes gross income that might have been deferred and relate to services performed in prior tax years. In that circumstance, the place where the taxpayer performed the services for that compensation will determine whether it is a charge for services performed within the City. The total payment of deferred income may exceed the amount originally deferred, and may often depend on the value of financial assets held by the payor immediately prior to payment. That variability is a component of the compensation calculation that the taxpayer agreed to when it elected to defer its compensation, and earned a right to it, and does not create a separate allocation analysis for the difference between the amount originally deferred and the amount paid. For example, if a taxpayer elected to defer a portion of its compensation from 2006 to 2017 and it performed 90% of the services necessary to earn that compensation in the City, it would treat 90% of the amount it receives pursuant to the NQP in 2017 as a charge for services performed in the City for purposes of its gross income percentage.

Some situations may require the exercise of Commissioner discretion to arrive at an equitable BAP.²⁹ For example, the information needed for accurate allocation of deferred income may not be available, or the taxpayer may have deferred income in multiple tax years and the balances are co-mingled and paid on a basis that makes it impossible to segregate the included income into amounts received for separate years. In the latter situation, DOF may, for example, blend allocation factors over multiple years.

Examples

The following examples demonstrate how the analysis in this Memorandum applies.

Example 1

Deferral Election

Partnership A enters into an NQP with Corporation B in 2012 that is valid under 409A and does not trigger the doctrine of constructive receipt or income recognition under any other rule of law or section of the IRC. Partnership A further elects, in 2012, to defer \$100x of the compensation it will earn from services it provides to Corporation B in the City in 2013. It performs all the required services within the City in 2013.

Distribution of Deferred Income, Year of Recognition

In 2018, the deferral ends and Corporation B distributes \$100x to Partnership A. Partnership A realizes an additional \$100x of gross income from services it provided half within and half without the City, and incurs \$10 of expenses attributable to the business.

Federal Tax Consequences

Partnership A does not recognize, in 2013, the amount of income it elects to defer, rather it recognizes \$200x of gross business income in 2018. In addition, it deducts \$10 for its expenses in 2018, which results in net business income equal to \$190x.

UBT Consequences

Partnership A does not recognize, in 2013, the amount of income it elects to defer, and the deferred compensation balance does not constitute a qualifying asset for purposes of the partial self-trading test in section 11-502(c)(4) of the Ad. Code. Partnership A, instead, recognizes \$200x of unincorporated business gross income (UBGI) in 2018 and no City modifications apply. In addition, it takes a \$10 unincorporated business deduction without modification in 2018, which results in unincorporated business entire net income equal to \$190x. Further, the gross income factor will be determined on a place of performance basis, with a BAP computed as follows:

| Factor | NYC | Everywhere | Percentage | Weight | Factor | BAP |
|----------|------|------------|------------|--------|--------|-----|
| Property | N/A | N/A | N/A | N/A | N/A | |
| Wages | N/A | N/A | N/A | N/A | N/A | |
| Receipts | 150x | 200x | 75% | 1 | 75% | 75% |

Partnership A must therefore allocate \$142.5x ($75\% \times \$190x$) to the City in 2018.

Example 2

Deferral Election

Partnership A enters into an NQP with Foreign Corporation B in 2002 that is valid under 409A and does not trigger the doctrine of constructive receipt or income recognition under any other rule of law or section of the IRC. Prior to the start of each of the 2003

²⁸The UBT states that a taxpayer should determine its gross income percentage by "dividing (A) the gross sales or charges for services performed by or through an agency located within the city, by (B) the total of all gross sales or charges for services performed within and without the city." Ad. Code §11-508(c)(3). It further states that "charges for services performed shall be allocated to the city to the extent that the services are performed within the city." Admin. Code §11-508(c)(3)(C).

²⁹Ad. Code §11-508(h), 19 RCNY §28-07(e)(1).

through 2008 tax years, Partnership A elects to defer a portion of the compensation it earns from services it performed for Foreign Corporation B in those years. Partnership A performs a portion of the required services each year in the City. In 2009, the parties amend the NQP to comply with the requirements of 457A, and provide that Partnership A's deferral of compensation attributable to services performed prior to January 1, 2009 will terminate on December 31, 2017.

The table below reflects: (i) the amounts Partnership A elects to defer in accordance with the requirements of 409A; (ii) the growth of the deferred amounts prior to distribution on December 31, 2017, assuming they were pegged to the total return of the S&P 500 index; and (iii) the percentages of services Partnership A performed in the City in exchange for the deferred income (i.e., the percentage of performance that occurred in the City, the "City %"):

| Income | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | Total |
|---------------|-------------|-------------|-------------|-------------|-------------|-------------|--------------|
| Deferral | \$50x | \$100x | \$500x | \$1000x | \$750x | \$200x | \$2600x |
| Growth | \$105.65x | \$193.5x | \$832.5x | \$1350x | \$1038x | \$540.6x | \$4060.25x |
| <i>Total</i> | \$155.65x | \$293.5x | \$1332.5x | \$2350x | \$1788x | \$740.6x | \$6660.25x |
| City% | 50% | 55% | 90% | 95% | 95% | 80% | - |
| City UBGI | \$77.83x | \$161.43x | \$1199.25x | \$2232.5x | \$1698.6x | \$592.48x | \$5962.09x |

Partnership A also provides NQPs to two employees, C and D, in each year that it participates in the NQP provided by Corporation B. Under their NQPs, the compensation C and D defers must grow or decline on the same basis as the compensation Partnership A defers. C and D work entirely in the City and elected to defer, on a combined basis, the following amounts:

| Compensation | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | Total |
|---------------------|-------------|-------------|-------------|-------------|-------------|-------------|--------------|
| Deferral of C / D | \$20x | \$30x | \$100x | \$300x | \$200x | \$50x | \$700x |
| Growth | \$42.26x | \$58.05x | \$166.5x | \$405x | \$276.8x | \$135.15x | \$1083.76x |
| <i>Total</i> | \$62.26x | \$88.05x | \$266.5x | \$705x | \$476.8x | \$185.15x | \$1783.76x |

Partnership A and its employees perform the required services between January 2003 and December 2008.

Distribution of Deferred Income, Year of Recognition

In 2017, the deferral ends for Partnership A, and individuals C and D. Corporation B distributes \$6,660.25x to Partnership A. Partnership A, in turn, distributes \$1783.76x to C and D. Partnership A also realizes \$200x of gross income from services it performs 1/10th in the City, and incurs \$50 of expenses attributable to the business. Partnership A pays \$40x in salary to current employees, including \$20x to an employee in the City, who worked in the office of an affiliate. It pays \$10 of rent for an office outside the City.

Federal Tax Consequences

Partnership A does not recognize, in 2003-2008, the amounts of income it elects to defer; rather, it recognizes \$6860.25x of gross business income in 2018. It also does not deduct, in 2003-2008, the amounts payable to C and D that they defer; rather, it deducts \$1833.76x for its payments to them and other expenses in 2017, which results in net business income equal to \$5026.49x.

UBT Consequences

Partnership A does not recognize, in 2003-2008, the amounts of income it elects to defer, and the net deferred compensation balance does not constitute a qualifying asset for purposes of the partial self-trading test in section 11-502(c)(4) of the Ad. Code. Partnership A, instead, recognizes \$6860.25x of UBGI in 2017 and no City modifications apply. It also does not deduct, in 2003-2008, the amounts payable to C and D that they deferred; rather, it combines those amounts with its other expenses in 2017 and takes an \$1833.76x unincorporated business deduction in 2017 and no City modifications apply, which results in unincorporated business entire net income equal to \$5026.49x.

The gross income factor will be determined on a place of performance basis, with the BAP computed as follows:

| Factor | NYC | Everywhere | Percentage | Weight | Factor | BAP |
|---------------|------------|-------------------|-------------------|---------------|---------------|------------|
| Property | \$0 | \$10x | 0% | 3.5 | 0 | |
| Wages | \$1803.76x | \$1823.76x | 98.9034% | 3.5 | 346.1619 | |
| Receipts | \$5982.09x | \$6860.25x | 87.1993% | 93 | 8109.5349 | |
| | | | Total | | 8455.6968 | 84.56% |

Partnership A must therefore allocate \$4250.40x (84.56% x \$5026.49x) to the City.

Example 3

Same facts as Example 2, except that Partnership A does not have the information necessary to divide the growth between the amounts deferred for each year from 2003 to 2008. In this instance, DOF may use the Commissioner's discretionary power under 19 RCNY §28-07(e)(2) to determine a fair and proper allocation of Partnership A's income. Based on the information available, it is possible to determine that the weighted average gross income percentage for the original amounts deferred, based on place of performance, is 90.48%, and DOF may determine that it is fair and equitable to characterize 90.48% of the growth as a charge for services performed in the City. On that basis the BAP would be computed as follows:

| Factor | NYC | Everywhere | Percentage | Weight | Final Factor | BAP |
|----------|------------|------------|------------|--------------|--------------|--------|
| Property | \$0 | \$10x | 0% | 3.5 | 0 | |
| Wages | \$1803.76x | \$1823.76x | 98.9034% | 3.5 | 346.1619 | |
| Receipts | \$6046.21x | \$6860.25x | 88.1340% | 93 | 8196.4620 | |
| | | | | Total | 8542.6239 | 85.43% |

Under this method, Partnership A would allocate \$4294.13x (85.43% x \$5026.49x) to the City.