November 18, 2016

Connecticut Tax Department Seeks Information on 2017 Offshore Deferred Compensation

On November 7, 2016, the Connecticut Department of Revenue Services sent an unusual letter to approximately 5,000 taxpayers asking them to advise the Department whether or not they expect to receive deferred compensation from offshore funds in 2017 so that the Department could evaluate "*the impact on an important sector of Connecticut's economy.*"

The letter references Section 457A of the Internal Revenue Code (IRC), which requires that certain nonqualified deferred compensation from offshore funds be taken into income for federal tax purposes no later than 2017. Since Connecticut bases its income tax on federal income, such deferred compensation would be taxable by Connecticut in 2017 as well.

The Department has been focusing on this income since at least 2014, when it proposed legislation, which was enacted by the General Assembly, to "*clarify that federal offshore hedge fund income is considered Connecticut-sourced income for nonresidents when attributable to services performed in Connecticut.*" Specifically, the legislation provides that the income of a nonresident includes "*his or her compensation from nonqualified deferred compensation plans attributable to services performed within the state, including, but not limited to, compensation required to be included in federal gross income under Section 457A of the Internal Revenue Code.*" CGS Section 12-711(a)(4).

The 2014 legislation focused on nonresidents, since residents of Connecticut already are taxed on 100 percent of their worldwide income (subject to certain exceptions not relevant here). Accordingly, 100 percent of any such offshore deferred compensation included in the 2017 federal income of a Connecticut resident would be included in their 2017 Connecticut tax base as well.

Nonresidents of Connecticut, on the other hand, are subject to Connecticut income tax only on income that is "*derived from or connected to sources within Connecticut"* (commonly referred to as "Connecticut-source income"). An example of Connecticut-source income would be compensation for services performed in Connecticut.

If such services are performed by the nonresident wholly within Connecticut, 100 percent of the compensation for such services would be considered Connecticut-source income. If, however, the services are performed both within and without Connecticut, then an allocation must be made to determine the portion of the compensation that properly is sourced to Connecticut.

The Connecticut income tax regulations provide a specific methodology for determining the portion of deferred compensation that constitutes Connecticut-source income, which uses a multiyear "look back" period. Under regulation Section 12-711(b)-19, the percentage of deferred compensation of an employee who performed services both within and without Connecticut that is Connecticut-source income is determined by dividing (i) the total compensation received for services performed in Connecticut during the look-back period by (ii) the total compensation received for services during such period. The look-back period consists of (a) the portion of the tax year in which the deferred compensation is received that expires prior to the receipt of the nonqualified deferred compensation and (b) the three immediately preceding taxable years. A separate calculation is made for each of those four periods of the compensation received for the performance of services within and without Connecticut.

At the time IRC Section 457A was enacted by Congress in 2008, it was estimated that many billions of dollars were held as deferred compensation in plans maintained by offshore funds. Commissioner Kevin B. Sullivan of the Department has

publicly stated that he expects the treatment of deferred compensation from offshore funds to be of significant interest to Connecticut, New York and New Jersey due to the concentration of fund sponsors and managers in those states.

We will continue to monitor this issue.