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The International Implications of §409A and its Impact on Multinational Companies

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On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004, which added to the Internal Revenue Code of 1986, as amended, a new §409A entitled "Inclusion in Gross Income of Deferred Compensation Under Nonqualified Deferred Compensation Plans." The Act dealt mainly with corporate tax issues for multinational and non-US companies. However, with the introduction of Internal Revenue Code §409A, the Act also made far-reaching and significant changes to the rules governing, and the tax treatment of, deferred compensation arrangements. Since the implementation of the Act, one of the most pressing issues affecting multinational companies has been the breadth, scope and international reach of §409A.

Section 409A imposes special challenges to multinational companies because these tax rules potentially impact employees that reside outside of the United States who are US citizens, non-resident aliens or resident aliens and are covered by local plans or the global plans of the multinational company. A violation of any of the applicable §409A requirements would result in tax penalties to individuals who are or may become subject to US income taxation. As the United States imposes income tax on the worldwide income of US citizens and resident aliens, §409A applies to *every* employee subject to US taxation worldwide who participates in a deferred compensation arrangement – either globally via a non-US multinational or through a local affiliate in a country other than the USA. Therefore, the provisions of §409A are applicable to worldwide income earned by US citizens working abroad (expatriates), resident aliens and US source income earned by foreign employees working temporarily in the United States (non-resident aliens).

The reach of §409A went well beyond the borders of the United States as it impacted employees employed outside of the United States who are US citizens or resident aliens covered by local or global plans of a multinational corporation. This was not an intended consequence of Congress and subsequent guidance (proposed and final) issued by the Department of Treasury and the Internal Revenue Service (IRS) has rectified and clarified the parameters of §409A and provided significant relief for multinational and non-US companies by carving out certain non-US plans and expatriate arrangements from the definition of "non-qualified deferred compensation plan".

Deferred compensation arrangements issued by foreign-owned operations or by US companies with operations abroad were not originally exempt from the application of §409A. However, under proposed and now final regulations issued by the IRS, there are exemptions that apply which are geared towards limiting the effect of §409A on non-resident aliens and US citizens or residents who participate in non-US plans. Employers worldwide now have until December 31, 2008 to review, inventory and bring their deferred compensation arrangements into compliance with §409A to avoid inadvertent violations of these tax rules.

This article will highlight the issues that employers must consider and it will also set out the specific exemptions aimed at limiting the effect of §409A on non-resident aliens and on US citizens or residents who participate in non-US plans. The proposed and subsequent final regulations issued by the IRS contain exemptions that permit both US citizens and resident aliens working abroad, and non-resident alien individuals working within the United States, to accrue benefits under foreign plans that do not meet the §409A requirements. However, where no specific exception applies, it will still be necessary for companies to amend their foreign arrangements to comply with the §409A requirements in order to avoid sanctions. It is noteworthy that, if a plan fails to comply, participating employees could be subject to immediate taxation and a 20% penalty plus interest accruing from the date the deferral was no longer considered subject to a "substantial risk of forfeiture". These results could be financially devastating to both the company and the participating employee. Therefore, it is imperative for multi-national and non-US companies alike to evaluate any arrangements that may be subject to §409A, including non-US plans and global employee mobility programs in order to ascertain any issues and to make the necessary changes and amendments to comply.

SECTION 409A

With the adoption of §409A, Congress elected to crack down on nonqualified deferred compensation plans. This legislation was prompted primarily by Enron-type scandals and §409A was implemented as a result of, or in response to, perceived abuses by Enron corporate executives who withdrew their nonqualified deferred compensation before the bankruptcy of the company. Under the new law, all "nonqualified deferred compensation plans" are covered. This term is defined very broadly and includes traditional deferrals of base pay, incentives, supplemental executive retirement plans, discounted stock options, phantom stock plans, stock appreciation rights, and other similar plans. Section 409A imposes very stringent restrictions and limitations on the timing of elections and distributions from nonqualified deferred compensation plans. A comprehensive discussion of the overall requirements of §409A is beyond the scope of this article but the main objective of §409A was to limit the times that an executive may be paid his/her nonqualified deferred compensation. The exact date of payment or a permissible payment event that will trigger the payment of the deferred compensation must also be specified in the plan document. The passage of this major tax bill applies to all compensation deferred from one calendar year to the next if it was first earned or became non-forfeitable on or after January 1, 2005. The rules require companies that receive personal services from a US tax-paying employee to carry out the following:

- document, in advance of the services, any arrangement used to defer receipt of any of the compensation earned by the employee and follow specific rules when making any elections to further defer that compensation (the deferral rules);

- document, in advance, when such deferred compensation can be paid and follow strict rules that limit the circumstances under which the employee can be paid such deferred compensation (the payment rules); and

- limit the types of funding arrangements that can be used to make payment (the funding rules).

Permissible payment events include:

- separation from service of the executive (as defined in §409A);

- death of the executive;

- disability of the executive (as defined in §409A); and

- a change in control of a corporation (as defined in §409A).

In addition, any compensation plan that could fall within the purview of §409A must be in writing. The final regulations provide that a "savings clause," which ensures that a plan will be administered consistently with §409A regardless of provisions to the contrary, will not protect a plan whose terms do not comply with §409A. Therefore, it is critical that employers and executives review their deferred compensation arrangements and ensure compliance with the tax rules.

Before implementation of the Act, deferred compensation that complied with the constructive receipt rules was taxed only at the time of payment and no penalties were imposed. However, §409A changes this standard and provides that amounts deferred under nonqualified deferred compensation plans are includible in income to the extent not subject to a substantial risk of forfeiture (i.e., vested) and not previously included in income, unless these arrangements meet the requirements of §409A.

If the arrangement does not meet the requirements of §409A, deferred amounts (including earnings and amounts deferred in earlier years, not previously taxed) are taxable to the participating employee on the date of vesting. The Act also imposes on the participant employee a penalty of 20% of the taxable amount required to be included in income as a result of non-compliance with the Act, plus interest at the income tax underpayment rate plus 1% from the date of deferral or, if later, the date of vesting. Section 409A is a significant change and, although it does not impose any specific penalties on the employer, compliance will be, in most cases, within the employer's exclusive control. Therefore, it is imperative that multinational companies recognize and understand the full impact of §409A on their US tax-paying employees.

Guidance from the Internal Revenue Service

Guidance issued by the IRS on the application of §409A has been issued piecemeal and in steps. Effective January 1, 2005, all arrangements subject to §409A are required to operate in good-faith compliance with the new law. Notice 2005-1, issued in December 2004, set out rules for this compliance.

In October 2005, the IRS issued proposed regulations, which specifically responded to, and addressed, several issues of concern to multinational corporations, including those dealing with:

- deferred compensation plans or arrangements maintained outside the USA with participants in a non-US jurisdiction who are subject to taxation in the USA on their worldwide income;

- plans maintained by multinational companies outside the USA but covering certain US-based employees; and

- plans maintained outside the USA and covering employees not subject to US taxation when participating in the plan or in an arrangement but who later become subject to US taxation.

On April 10, 2007, the Department of Treasury and the IRS issued final regulations interpreting §409A.[1] These final regulations contain several exemptions that permit both US citizens and resident aliens working abroad, and non-resident aliens working within the USA, to accrue benefits under foreign plans that do not meet the §409A requirements. However, where no exemption applies, it will be necessary for employers to amend the foreign arrangement to comply with the §409A requirements in order to avoid sanctions.

The final regulations provided that good-faith compliance would end on December 31, 2007 and as of

January 1, 2008, full documentary and operational compliance with the final regulations would be required. On October 22, 2007, the IRS issued Notice 2007-86, which extended the deadline for compliance with the final regulations under §409A until January 1, 2009. Therefore, all relevant deferred compensation arrangements must be amended by December 31, 2008 to comply with the final regulations.

US CITIZENS AND/OR RESIDENT ALIENS

Complying with the §409A rules involves special challenges for multinational companies that employ US citizens and/or resident aliens. The USA taxes its citizens on their worldwide income and also taxes aliens who become US residents on their worldwide income while they are residents. In addition, the USA taxes non-resident aliens on their US source income, which generally includes compensation from personal services earned within the United States. Where the executive concerned is a non-resident individual, any compensation relating to services performed in the United States will be regarded as income effectively connected with a US trade or business and therefore subject to US taxation.

The §409A rules contain a number of exemptions which create at least some planning opportunities for multinational companies that have deferred compensation arrangements located outside the USA which include participants who are subject to taxation in the USA on their worldwide income. In application, §409A will not extend taxation to individuals not subject to US federal income tax before implementation of the Act. In accordance with this general principle, there are several exemptions aimed at limiting the effect of §409A on non-resident aliens and on US citizens or residents who participate in non-US plans, some of which I will consider in turn.

Plans Covered by Tax Treaties

Section 409A does not apply to compensation that would not be subject to US federal income tax under a tax convention or other bilateral or multilateral agreement to which the USA is a party. Section 409A does not apply to deferred compensation contributions or accruals to the extent that they are exempt from US taxation under an applicable tax treaty. A plan is not considered a "deferred compensation plan" to the extent "amounts which constitute income" under the plan are specifically excluded from US income by treaty.

Section 409A does not supersede any double tax treaty provisions that govern the taxation of foreign plans. The United States has income tax treaties with a number of foreign countries. Under these treaties, residents (not necessarily citizens) of foreign countries are taxed at a reduced rate, or are exempt from US income taxes on certain items of income they receive from sources within the United States. These reduced rates and exemptions vary among countries and specific items of income.

Foreign Social Security Agreements

Amounts deferred under a foreign social security system are also exempt from §409A. A social security system of a foreign jurisdiction is not deemed a qualified deferred compensation plan subject to §409A to the extent that the benefits paid or the contributions made under the system are covered under a "totalization agreement" between the USA and any foreign jurisdiction in accordance with §223 of the Social Security Act or if the benefits are paid by, or the contributions are made to, a government-mandated plan as part of that foreign jurisdiction's social security system. Therefore, in general, §409A will not apply to a non-US social security benefit that is (i) subject to a totalization agreement or (ii) government mandated.

Tax Equalization Agreements

Tax equalization payments often provide for deferred compensation as they are delayed. The applicable exemption provides that §409A does not apply to tax equalization payments (to offset differences between US and foreign effective tax rates where income is subject to tax in more than one jurisdiction), so long as they are paid:

(a) by the end of the second taxable year following the year in which the service provider's US tax return is to be filed; or

(b) no later than the end of the second taxable year of the service provider in which its US federal income tax return is required to be filed (including any extensions) for the year to which the compensation that is subject to the tax equalization payment relates or, if later, the second taxable year of the service provider beginning after the latest such taxable year in which the service provider's foreign tax return or payment is required to be filed or made for the year to which the compensation subject to the equalization payment relates.

In the case of (a), the §409A rules continue to allow most tax equalization plans, so long as the tax equalization payments are not deferred any longer than the close of the second calendar year beginning after the calendar year in which the US tax return was due (including extensions). Alternatively, in the case of (b), if the payments arise due to an audit, litigation or similar proceeding, the right to the payments is not subject to §409A if those payments are scheduled and are made in accordance with the §409A fixed schedule of tax gross-up payments.

Specific Exemptions

US citizens are subject to taxation on their worldwide income. Therefore, all compensation, regardless of source, deferred under a nonqualified deferred compensation plan is subject to §409A, except in the following scenarios:

– US citizens working overseas may defer up to the difference between the amount of "foreign-earned income" capable of being excluded from gross income under §911* and the amount actually paid to the employee, each taxable year (the limit on

* The §911 exclusion is available if the individual (i) has his "tax" home in a foreign country and (ii) is a US citizen and has been a "bona fide resident" of the foreign country for an "uninterrupted period which includes an entire taxable year" *or* is a US citizen or US resident and has been physically present in a foreign country for at least 330 consecutive days in a 12-month period.

excludable income is currently US$85,700 of income earned during the tax year);

– any amount not subject to taxation as a result of a tax treaty;

– nonelective deferrals of foreign-earned income under a broad based foreign retirement plan (up to the §415 limits);

– contributions to a funded foreign arrangement subject to taxation under §402(b)*; and

– any totalization and tax equalization payments.

In addition, resident aliens are subject to worldwide taxation and the noted exceptions above also apply to US residents. Moreover, there are two additional exceptions:

– amounts previously deferred and vested while the individual is working overseas are exempt; and

– in the year the individual becomes a resident alien, special transition relief will apply.

Certain other foreign plans not covered by treaty are exempt from §409A provided that:

– the individual participating in the plan is a non-resident alien, a resident alien under the substantial presence test (i.e., is not a greencard holder) or a bona fide resident of a US possession (Guam, American Samoa, the Northern Mariana Islands, Puerto Rico or the US Virgin Islands);

– the foreign plan is in writing; and

– the foreign plan is "broad-based", meaning that it is non-discriminatory as to participation and as to the provision of benefits, it actually provides significant benefits to covered employees and, by its terms or under local law, it has restrictions on the use of the benefits under the plan other than for retirement.

Where US citizens and resident aliens who are not bona fide residents of a US possession (as noted above) participate in a broad-based foreign plan (also noted above), the contributions are exempt from §409A provided that:

– the contributions are non-elective;

– the contributions are made from "modified foreign-earned income" (i.e., foreign-earned income without the requirement that the individual be a "qualified individual", as defined in §911, relating to the foreign-owned income exclusion);

– the limits applicable to US defined benefit or defined contribution plans under §415 are not exceeded; and

– the individual is not eligible to participate in a US qualified plan.

In addition, foreign separation agreements are not considered §409A plans if the separation pay is required to be provided under the applicable law of a foreign jurisdiction, and if it only applies to foreign-earned income from sources within that jurisdiction. This exemption is applicable to both voluntary and involuntary separations.

Non-resident aliens are generally subject to §409A for deferred compensation earned for personal services performed in the USA that is not otherwise exempt from federal income taxation under the Internal Revenue Code or an applicable treaty. There are two exceptions. The first exception is that the compensation is not subject to §409A insofar as the amount of the compensation deferred under a foreign plan during a taxable year of the service provided that is based on services performed in the United States by a non-resident alien does not exceed the applicable dollar limit under §402(g) for the taxable year. For this purpose, a "foreign plan" means a plan that, together with all similar plans, is maintained by a service recipient for a substantial number of participants, the majority of whom are non-resident aliens or resident aliens classified as resident aliens solely under a different part of the Code.[2] The second exception is a one-year grace period to bring deferred compensation plans into compliance when an individual becomes a resident alien. Deferrals of income under a plan that might otherwise be a deferred compensation plan are exempt from §409A if made from income that would have been excludible from gross income for US federal income tax purposes under the Code, if paid to the employee at the time the legally binding right to the compensation first arose or, if later, when the legally binding right was no longer subject to a substantial risk of forfeiture. In addition, the plan is in compliance with the time and form of payment requirements of §409A for the first taxable year in which the individual is a resident alien if the plan is amended to comply with those requirements by the end of that year.

Finally, §409A generally treats assets set aside in, or transferred to, offshore trusts (or comparable arrangements) as transfers of property which are required to be included in income under §83. Notice 2006-33, provided that assets set aside or transferred on or before March 21, 2006, could avoid review under §409A if the plan conformed with the requirements of §409A(b) and any applicable guidance on or before December 31, 2007. It is important to note that this relief expired after December 31, 2007 and it was not extended by Notice 2007-78, or Notice 2007-86. However, until further guidance is issued, companies and employees may still rely on a reasonable, good faith interpretation of §409A when determining if a particular agreement is subject to this section.

WHAT SHOULD COMPANIES BE DOING NOW?

The first and possibly most daunting task is to identify those deferred compensation arrangements that may need to be addressed and fall within the scope of §409A. Because the threshold definition of "deferred compensation" is extremely broad in its application, several arrangements may fit within this category and are

* This exemption applies with respect to non-US plans that hold contributions in trust. Because these contributions are subject to US federal income tax under §402(b), they are exempt from §409A.

therefore potentially subject to §409A. Examples of deferred compensation arrangements may include (and this list is not exhaustive): employment agreements; severance plans and agreements; offer letters; consulting or independent contractor agreements; change in control agreements; director fee deferral agreements; bonus plans; deferred compensation plans; equity-based compensation plans or arrangements; phantom equity plans; 457(f) plans (tax-exempt and governmental entities); stock options; restricted stock or stock appreciation rights; reimbursement arrangements; SERPs*, Excess or Supplemental Benefit Plans; Incentive or Profit Participation Plans; and/or bonus or commission plans.

Additionally, it is recommended that executives examine their employment agreements and, if an agreement references any benefits granted through a separate document, these agreements will need to be reviewed. If an executive is no longer working for the company, but is still receiving compensation under a separation agreement, these documents will likewise need to be reviewed and, where necessary, renegotiated or restructured to comply with §409A. In addition, if an executive left after 2004, when §409A went into effect, and expects to receive future payments or nonqualified benefits, these agreements will also need to be reviewed.

Once the applicable deferred compensation arrangements are identified, the next practical step is to determine whether a particular exemption applies and, if not, the process of making the modifications required to comply with §409A can begin.

As noted above, §409A is already in effect and this year is ultimately the last opportunity for employers to redesign and amend their deferred compensation arrangements. Employers and employees should now be reviewing their compensation arrangements to determine the extent to which a deferred compensation arrangement is subject to §409A.

It is recommended that, at a minimum, the following steps should be undertaken by multinational and non-US companies to determine whether a deferred compensation arrangement is subject to §409A:

- Review and identify all compensation arrangements potentially subject to §409A and, in particular, review all plans that defer compensation or could defer compensation payable to an employee outside his/her respective home country.

- Consider amending plans, arrangements and other agreements to limit deferrals to the difference between the maximum foreign earned income exclusion under §911(b)(2)(d) and the amount actually excludable from the individual's gross income.

- Identify those "deferred compensation arrangements" that are exempt from the application of §409A – either specifically exempt or via the exemptions set out in this section. In particular, identify any totalization agreements that may exist that will exempt non-US social security benefits from §409A; identify any jurisdiction that is not covered by a totalization agreement but where the social security system requires employees to contribute to government-mandated plans as benefits attributed to such contributions will be exempted from the application of §409A.

- Review expatriate agreements to ascertain if the company is responsible for §409A taxes arising from a tax equalization arrangement and make any requisite changes to the arrangement to rectify this situation.

- Review and, if necessary, reform tax equalization programs not protected by a specific tax treaty with the USA to ensure that these programs comply with §409A.

- Review and examine any and all deferred compensation plans and arrangements for executives as well as directors and partners, as the §409A Regulations are not limited to employees.

- Review retirement plans maintained by non-US companies that cover individuals working in the USA, but who are neither US citizens nor residents, to confirm that they qualify for the "broad-based retirement plan" exemption.

- Ensure that any future deferred compensation arrangements provided to resident aliens or non-resident aliens only defer income to a specific date.

- Discontinue any repatriation allowances, other than those plans grandfathered (pre-2005), that pay employees on a specific event and revise them to provide payment on a specific date.

- Monitor and review expatriate and global mobility programs to confirm that any change in the residency status of a non-resident alien who ultimately moves to the USA does not result in a breach of §409A.

- Document separately compliance with the good-faith compliance requirements of §409A.

This provides employers with plenty to do. Ω

* Supplemental Executive Retirement Plans

References

1 The final regulations may be found at: http://www.treasury.gov/press/releases/reports/td9321.pdf

2 IRC §7701(b)(1)(A)(ii).

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