

IRC Section 409A and Foreign Deferred Compensation

*Peter Alwardt and Eisneramper LLP**

As the global economy becomes increasingly integrated, many U.S. middle-market companies find themselves expanding into foreign markets including manufacturing, sales, and distribution facilities abroad. In addition to hiring local nationals, they often must assign U.S. executives/employees or third-country nationals to work in these new markets. Among the host of issues confronting such companies, deferred compensation whether for retirement or as part of executive agreements is one of the most important, but at the same time complex and frustrating. Following publication of final regulations under Internal Revenue Code (“IRC”) section 409A (“section 409A”) in 2007, many large multinational companies have brought their programs into compliance with the final regulations. For many middle-market companies moving into foreign markets, the rules, as they apply to foreign deferred compensation, are new. Thus, a

review of the regulations under section 409A and their impact on existing or proposed deferred compensation plans may be helpful.

OVERVIEW OF SECTION 409A

Section 409A imposes restrictions on the deferral of compensation by employees, directors, and other independent contractors (collectively “employees”). It was enacted as a response to the Enron bankruptcy—because executives were able to receive millions of dollars in payouts shortly before the company’s bankruptcy filing—to limit the control that employees who are U.S. taxpayers have over the timing of the recognition of income from deferred compensation arrangements in which they participate.

Deferred compensation under section 409A is defined very broadly and potentially includes any arrangement under which

an employee has a right to receive compensation earned in one year and paid in a subsequent taxable year. This can include, but is not limited to, retirement plans, bonus plans, incentive compensation plans, severance arrangements, certain equity plans, and individual employee agreements.

Key Point: In many companies with foreign operations, an employee who is a U.S. taxpayer may be a participant in foreign retirement plans, covered by foreign deferred compensation programs, or covered by other policies or other arrangements, such as individual employment agreements, that contain items of deferred compensation. Consequently, these foreign plans and programs need to be reviewed to determine whether they comply with, or meet one of the exemptions from, section 409A.

Generally, deferred compensation is taxed under section 409A when it is no longer sub-

* peter.alwardt@eisneramper.com. EisnerAmper provides broad and multidisciplinary guidance to clients on Human Capital planning and compliance, for which you may contact either Mr. Alwardt as above or Mr. James Hatch, james.hatch@eisneramper.com. See generally www.eisneramper.com.

ject to a substantial risk of forfeiture as defined in the final regulations. Further, to meet the rules of section 409A, a plan must provide that distributions from the deferred compensation plan are only allowed at separation from service, death, a specified time (or under a fixed schedule), change in control of a corporation, occurrence of an unforeseeable emergency, or if the participant becomes disabled. The plan may not allow for the acceleration of benefits, except as provided by regulation, and if the employee is electing to defer some of his current salary, the deferral must be made no later than the close of the preceding tax year, or at such other time as provided in final regulations. Compliance with section 409A is critical because the full impact of a failure to comply is felt by the employee—typically an executive or other key employee—who will have to pay current income taxes on the deferred amounts along with a 20% excise tax and interest if the deferred compensation is taxable in a prior year as a result of the failure to comply.

FOREIGN PLANS AND SECTION 409A

Because the reach of U.S. income tax rules is global for U.S. taxpayers, section 409A generally applies to foreign compensation arrangements

that generate taxable income for such taxpayers. Thus, the entire income of U.S. citizens and resident aliens is taxable under the IRC regardless of where it is earned. As a result, it is critical when reviewing foreign plans that the employee's status as a U.S. citizen, resident alien, or nonresident alien be determined.

Key Points: Once the employee's status is determined, the following rules of thumb should be kept in mind:

- If a U.S. citizen or resident alien is entitled to deferred compensation, then that deferred compensation may be subject to section 409A regardless of where it was earned;
- If a nonresident alien is entitled to deferred compensation, then that deferred compensation may be subject to section 409A only if the underlying services were performed in the United States; and
- There are several exemptions under section 409A, which are discussed below.

SPECIFIC EXEMPTIONS OF FOREIGN DEFERRED COMPENSATION UNDER SECTION 409A

Tax Treaties

The first step in determining whether section 409A applies to a company's foreign deferred compensation plan is always to review the income tax treaty between the U.S. and the foreign jurisdiction, if any. Depending on its terms, the treaty could preempt the taxation principles discussed above which would effectively prevent the U.S. from taxing the foreign deferred compensation.

Foreign Social Security Systems

Section 409A does not apply to benefits paid pursuant to a foreign social security system, if the benefits are provided under a government mandated plan or a plan covered by a totalization agreement between the U.S. and the foreign country in which the employee is working.

Tax Equalization Agreements

Payments made to an employee under tax equalization agreements are not subject to section 409A, if such payments are made no later than the end of the second calendar year beginning after the calendar year in which a U.S. income tax

return must be filed (including extensions) for the year to which the tax equalization payment relates.

Foreign Separation Pay Plans

Section 409A does not apply to amounts paid pursuant to a foreign separation pay (severance) plan required under the laws of a foreign jurisdiction. The amount exempted under this exception is limited to the foreign earned income from sources within the country that mandates the separation pay.

Section 402(b) Trust Exemption

Section 409A provides that if an employee actually receives a distribution of “property”—defined generally to include the transfer of a beneficial interest in a trust or annuity plan—then there is no deferral of compensation under section 409A just because the value of the property transferred is not currently includible the employee’s income, due to the employee not being vested in the property or the property being subject to a substantial risk of forfeiture. Section 409A treats a transfer of a beneficial interest in a trust as a transfer of property for the purpose of this exemption to the extent the transfer of the beneficial interest is subject to IRC section 83 or IRC section 402(b).

Key Point: Many foreign deferred compensation and retirement plans use trusts to fund benefits for participants that are or would be considered IRC section 402(b) trusts and are not subject to the claims of general creditors of the company. Accordingly, such plans would be viewed as a transfer of property to the employee that is covered under this exemption from section 409A.

BROAD-BASED FOREIGN RETIREMENT PLANS

Compensation deferred under certain broad-based foreign retirement plans is also excluded from section 409A. Such plans are defined generally as retirement plans that include a broad group of employees, substantially all of whom are active-participant nonresident aliens, and that provide significant benefits for a substantial majority of covered employees on a non-discriminatory basis.

Key Point: This exemption is focused on foreign deferred compensation plans maintained primarily for foreign employees but including certain U.S. taxpayers.

This blanket exemption applies only to foreign nationals who reside in the United States, but not to lawful U.S. permanent residents. A much more limited version of the exemption ap-

plies to U.S. citizens and lawful permanent residents. This exemption applies to non-elective deferrals (generally employer contributions to a foreign plan) of foreign earned income and only applies to non-elective deferrals within the IRC section 415(b) or (c) limits depending on whether the plan is a defined benefit plan or a defined contribution plan. Further, the non-elective deferral exemption is not available to employees for any year in which they are simultaneously eligible to participate in a broad-based foreign retirement plan and a U.S. tax qualified retirement plan. Finally, if the foreign plan in question allows both non-elective and elective deferrals, the exception for the non-elective deferrals is allowed only if the non-elective deferrals are segregated and distinct from the elective deferral amounts.

FOREIGN EARNED INCOME EXEMPTION

Section 409A does not apply to compensation deferred by a U.S. citizen or resident alien working abroad to the extent (i) such deferred compensation would have constituted excludible foreign earned income as defined in IRC section 911, had it been paid currently, and (ii) the maximum amount available as excludible foreign earned income for the relevant taxable year (\$92,900 in 2011) is not

otherwise used by the taxpayer. The usefulness of this exemption is likely to be limited, as the foreign earned income of a U.S. citizen or resident alien working abroad typically exceeds the dollar amount.

Compensation Deferred by Nonresident Aliens (including transition to Resident Alien status)

As logic dictates, section 409A does not apply to compensation deferred by a nonresident alien, if the compensation would not have been subject to U.S. income tax had it been paid to the nonresident alien at the time that the legally binding right to the compensation first arose or, if later, the time when the legally binding right was no longer subject to a substantial risk of forfeiture. A similar exemption applies to compensation deferred by a bona fide resident of a U.S. possession (Guam, American Samoa, the Northern Mariana Islands, or Puerto Rico). Also, section 409A does not apply to amounts up to the IRC section 402(g) limit (\$16,500 in 2011) deferred by a nonresident alien under a foreign deferred compensation arrangement, even if such amounts are related to services performed in the U.S. and are not otherwise excluded from U.S. income taxation by an international tax treaty.

For employees who defer

compensation in a year in which they transition from nonresident alien to U.S. resident alien status, section 409A provides a limited grace period by which the deferred compensation arrangement may be amended to comply with (or be excluded from) the final regulations. The grace period, which ends on December 31 of the calendar year in which the employee becomes a resident alien, is only available to those individuals who were nonresident aliens for the five preceding calendar years.

COMPLYING WITH SECTION 409A

Given the complexity of section 409A and the opportunity to maintain happy employees—recall that all taxes and penalties are levied against the employee, so these need to be minimized—it is important for companies just starting operations in foreign jurisdictions to get in front of issues arising out of section 409A. To help assure compliance it may be useful to consider the following actions:

- Consider hiring outside advisers to review existing plans and programs, review or design plans and programs that are being considered for implementation for outbound and inbound employees, and help design administrative

procedures for internal use.

- Assign responsibility and train internal resources domestically to administer the program and also provide training to human resource personnel, if any, in foreign locations to make them sensitive to the issues around section 409A.
- Create a relatively uniform program of compensation and benefits for outbound and inbound employees in order to minimize complexity, enhance the understanding of 409A issues within the benefits package, and ease the administration for those responsible. This includes knowing in which countries the employees on assignment will be subject to income tax.
- Utilize the IRS document correction program under Notice 2010-6 (as amended by Notice 2010-80) to correct existing document problems related to section 409A.

CONCLUSION

Compliance with section 409A is difficult even for companies that operate only domestically!

Adding foreign operations requires middle-market compa-

nies to create efficient internal compliance and administration | procedures, in order to minimize risks and costs associated with | foreign deferred compensation arrangements.