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Executive Compensation

The Global Reach of IRC Section 409: Newly Effective Rules Governing Foreign Deferred Compensation Arrangements Present Operational Challenges in 2009 and Beyond

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When, on October 22, 2007, the IRS issued Notice 2007-86, extending to the end of 2008 the period for reasonable good-faith compliance with Internal Revenue Code Section 409A (IRC Section 409A) and applicable guidance, cheers of joy (or at least sighs of relief) among employee benefits professionals could be heard ringing throughout the land. But alas, the extended honeymoon is over and the specter of audits and potentially stiff penalties for compliance failures loom. To be blunt, the next couple of years promise to be challenging for everyone involved in administering nonqualified deferred compensation arrangements, and the stakes are high. Lest our counterparts abroad feel left out, the operational challenges presented by IRC Section 409A will generally apply to foreign plans as well, putting “on the hook” countless multinational

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companies with US taxpayers participating in their deferred compensation arrangements, to say nothing of the employees and service providers themselves, who are directly liable for the tax penalties levied by IRC Section 409A.

After a brief refresher on deferred compensation in the post-409A landscape, this article will lay out the general applicability of IRC Section 409A to US taxpayers participating in a foreign deferred compensation plan, as well as the numerous exemptions available under applicable IRS regulations (the Final Regulations). Finally, we will offer a few ideas to assist multinational companies in determining which, if any, of their plans might be considered “nonqualified deferred compensation” within the meaning of IRC Section 409A, and how to coordinate efforts between local benefits delivery staff and service providers to avoid running afoul of IRC Section 409A.

IRC Section 409A Applicability, Generally

Section 409A of the Internal Revenue Code imposes restrictions on the deferral of compensation by service providers, including employees, directors, and other independent contractors. It is designed to limit the level of control that service providers, who are US taxpayers, have on the timing of recognition of income vis-à-vis deferred compensation arrangements. Failure to comply with IRC Section 409A results in current taxation of the deferred amounts, along with a 20 percent excise tax (plus interest in the event of late payment of taxes).

Moreover, IRC Section 409A provides for plan aggregation, meaning that similar types of deferred compensation arrangements for an employee would be treated as a single plan for the purposes of calculating the scope of the adverse tax consequences provided for under the IRC. For instance, a non-compliant feature in a service provider’s severance arrangement would affect all severance-based arrangements in which that service provider participates. The Final Regulations do, however, identify amounts deferred under foreign plans as distinct from, and thus not subject to aggregation with, amounts deferred under domestic plans.

Deferred compensation, for the purposes of IRC Section 409A, is defined very broadly, and potentially includes any arrangement under which a service provider has a right to receive compensation in subsequent taxable years. This can include pension plans, savings plans, incentive compensation, severance arrangements, and individual employee agreements, to name but a few.

Because a service provider who is a US taxpayer may be a participant in foreign deferred compensation plans, or be otherwise covered by foreign deferred compensation programs, policies or other

arrangements (including individual agreements with items of deferred compensation), such foreign arrangements should be reviewed to ensure that they either comply with, or are otherwise exempt from, IRC Section 409A.

US Tax Law in the Multinational Context

As a general rule, IRC Section 409A does apply to foreign compensatory arrangements that generate compensation taxable in the United States. But how, precisely, is such compensation defined? Broadly speaking, the scope of the US tax scheme is in character universal rather than territorial. As such, the entire income of US citizens and resident aliens is taxable under the Internal Revenue Code (and thus, subject to IRC Section 409A) irrespective of its source. Note that non-resident aliens are subject to US tax only on income whose source is within the United States. Accordingly, when evaluating these arrangements, the service provider's status as a US citizen, resident alien, or nonresident alien must be determined.

Even after the service provider's citizen/alien status is determined, questions may remain about how to classify the source of income for tax purposes. IRC Section 861(a)(3) and IRC Section 862(a)(3) provide that the source of compensation received for services performed is the place where the services are performed. This rule applies whether compensation is paid contemporaneously with the service or at a later date pursuant to a deferred compensation arrangement.

IRC Section 409A states that an effective deferral of recognized income from compensation can be achieved only if all applicable requirements of IRC Section 409A are complied with in plan operation and are reflected in the relevant documents. Violating IRC Section 409A, either in form or operation, triggers the sanctions enumerated above. Therefore, if it is determined that IRC Section 409A may have an impact on a foreign compensatory arrangement, then at a bare minimum, the following rules of thumb should be kept in mind:

- If a US citizen or resident alien is entitled to an item of deferred compensation, then that item of deferred compensation potentially is subject to IRC Section 409A irrespective of where it was earned;
- If a nonresident alien is entitled to an item of deferred compensation, then that item of deferred compensation potentially is subject to IRC Section 409A if and only if the underlying services were performed in the United States; and
- There are a myriad of exemptions under the Final Regulations, which are detailed below.

Exemptions Under Final Regulations, Generally

Note first that an overarching consideration for multinational companies in determining what to do about IRC Section 409A is the application of any relevant income tax treaties, which depending on their terms could supersede the principles described above and prevent the United States from taxing certain items of compensation to prevent double taxation.

IRC Section 409A does not apply to benefits paid pursuant to a foreign social security system apparatus, provided that the benefits are provided and contributions are made under a government-mandated plan or a plan covered by a totalization agreement between the United States and the relevant foreign country.

Further, IRC Section 409A does not apply to payments made under tax equalization agreements, provided that such payments are made no later than the end of the second calendar year beginning after the calendar year in which a US income tax return must be filed (including extensions) for the year to which the tax equalization payment relates. Notably, this carve-out for equalization arrangements also applies to arrangements involving reimbursements of US taxes that exceed foreign taxes.

Treatment of Compensation Deferred by US Citizens and Resident Aliens for IRC Section 409A Purposes

IRC Section 409A does not apply to compensation deferred by a US 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 (for 2009, \$91,400) is not otherwise used by the taxpayer. Any earnings (as defined in 1.409A-1(o) of the Final Regulations) on the deferred compensation are excluded from IRC Section 409A treatment as well.

Also exempted from IRC Section 409A treatment is compensation deferred under certain broad-based foreign retirement plans, defined generally as retirement plans that include a wide range of employees, substantially all of whom are active-participant nonresident aliens, and that provide significant benefits for a substantial majority of such covered employees on a nondiscriminatory basis. This blanket exemption applies only to foreign nationals who reside in the United States, but not lawful permanent residents. A limited version of the exemption, which applies to US citizens and lawful permanent residents, applies with respect to nonelective deferrals of foreign earned income within certain IRC limits. Specifically, the

nonelective deferrals exception applies only up to the limits set for US qualified employer plans and is not available to individuals for any year in which they are simultaneously eligible to participate in a broad-based retirement plan and a US qualified employer plan. If the plan in question allows both nonelective and elective deferrals, the exception for the nonelective deferrals is permitted only if the amounts deferred through nonelective deferrals are segregated and distinct from the elective deferral amounts. Again, any earnings credited on these deferral amounts are exempted as part of this exemption.

For individuals who defer compensation in a year during which they transition from nonresident alien to resident alien status, the Final Regulations provide for a limited grace period by which the deferred compensation arrangement may be amended to comply with (or be excluded from) IRC Section 409A. The grace period, which extends to December 31 of the calendar year in which the individual becomes a resident alien, is only available to those individuals who were nonresident aliens for the five preceding calendar years.

Note that the general principles of IRC Section 402(b) continue to apply, IRC Section 409A notwithstanding. To the extent that foreign deferred compensation arrangements are funded and contributions are made by or on behalf of US citizens or resident aliens to a trust (or similar funding vehicle) that is not qualified under IRC Section 501(a), such contributions constitute currently taxable transfers.

Treatment of Compensation Deferred by Nonresident Aliens for IRC Section 409A Purposes

IRC Section 409A does not apply to compensation deferred by a nonresident alien, provided that the compensation would not have been includible in US gross income for federal tax purposes 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 at which such legally binding right was no longer subject to a substantial risk of forfeiture. Functionally, this exemption permits a nonresident alien to work and defer compensation while abroad, and then to subsequently retire in the United States without having to comply with the requirements of IRC Section 409A. A similar exemption applies to compensation deferred by a bona fide resident of Guam, American Samoa, the Northern Mariana Islands, or Puerto Rico.

Also, IRC Section 409A does not apply to *de minimis* amounts (for 2009, up to \$16,500) deferred by a nonresident alien under a foreign deferred compensation arrangement, even if such amounts are earned for services performed in the United States and are not otherwise excluded from US taxation by way of international tax treaty.

Practical Advice and Best Practices

To suggest that the application of IRC Section 409A in the context of an increasingly global economy is complicated would be an understatement. As we have seen, the application of IRC Section 409A (or the operation of one of its myriad exemptions) is often dependent upon a confluence of variables and is rife with traps for the unwary. The simple fact that most non-US human resources professionals have had very little reason to be well-versed in the US Tax Code adds another layer of difficulty.

As in the case of domestic employers, the first step in tackling IRC Section 409A is simply to undertake a compilation of plans, arrangements, and other practices that might constitute deferred compensation subject to IRC Section 409A. At this preliminary “inventory” stage, it is advisable to liberally include any plan, arrangement, or practice. Because this inventory will form the basis for the company’s compliance efforts going forward, it is far preferable to flag something that turns out to not be subject to IRC Section 409A than the other way around. The unique challenges in such an undertaking for the multinational employer and its foreign-based human resources staff are the lack of familiarity with IRC Section 409A principles as well as disconnects in the terminology used by professionals in different corners of the world.

The best way to surmount these obstacles in the completion of an overinclusive inventory of foreign plans potentially subject to IRC Section 409A is a two-pronged approach of education and ownership. Obviously it would be impractical for local human resources staff to learn a US Tax Code provision as dense as IRC Section 409A inside and out. But knowing the basics, with an emphasis on the ability to spot potential IRC Section 409A–related issues in the plans that they administer, is crucial. Additionally, it is advisable to instill within local human resources staff a sense of ownership in not only the completeness of the inventory, but also in this process as a whole, especially in light of the ongoing monitoring obligation discussed below. This compilation and review by the multinational employer’s US tax and benefits counsel should be completed as soon as possible.

Once the plans and other deferred compensation arrangements are assembled in one place, the next step is to take a look at the employee population to determine, from an operational standpoint, how to comply with IRC Section 409A. As noted above, obligations under IRC Section 409A are often contingent on whether the service provider at issue is a US citizen, resident alien, or nonresident alien. Many times this information will be easy to determine, especially in cases of transfer within a multinational from the United States to an office abroad. But what about local hires? Often local human resources will have no known reason to know what a service

provider's citizenship or residency status is with respect to the United States, and often local laws might inhibit a sufficient inquiry. Thus, it is important to (i) implement procedures that ascertain the population data that the company does have on its employees; and, where such data is for whatever reason unattainable, (ii) provide notice to all service providers to consult with their own financial advisors in connection with potential adverse tax consequences of their compensation arrangements with the company.

Compliance does not end there. After a thorough review of the company's plans and service provider population, the work shifts to the day-to-day compliance with the operational requirements of IRC Section 409A. There is an ongoing obligation to monitor how deferred compensation arrangements potentially subject to IRC Section 409A are being administered. It is recommended that a local IRC Section 409A liaison be designated. Rather than residing informally within the purview of an individual, such a liaison should be folded into the formal, explicit job responsibilities of a particular post within the HR office's structure. The responsibilities of this liaison would include the monitoring of plan modifications and the identification of new plans that might be subject to IRC Section 409A, and then to report those developments to US benefits and tax counsel. Again, by developing a clear compliance strategy and establishing open lines of communication between US counsel and its global human resources apparatus, multinational companies can manage the challenges presented by IRC Section 409A in the foreign plan context.

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