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Employer Services Advisory

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Companies Should Be Reviewing The Impact of 409A On International Arrangements

The broad provisions of Section 409A of the Internal Revenue Code of 1986, as amended (“409A”) reaches beyond U.S. borders. In addition to the typical compensation arrangements between a U.S. company and its U.S. employees, 409A can also apply to compensation arrangements between a U.S. or non-U.S. company and U.S. employees or other service providers working outside of the U.S., as well as certain foreign nationals working in the U.S. If an arrangement fails to comply with 409A, the service provider incurs immediate taxation on the applicable deferred compensation and all similar arrangements that are no longer subject to a substantial risk of forfeiture (generally, “vested”), plus a 20% federal penalty, plus interest, plus state penalties in certain states (e.g., California). The company will have tax withholding and reporting obligations, and potential joint and several liability for taxes it fails to timely report and withhold. Accordingly, it is important that employees and other service providers who are or may become subject to U.S. taxation and the companies for whom they perform services, review their compensation arrangements to ensure that they are structured in a manner that either is exempt from, or complies with, 409A.

Who Is Covered? As a general rule, 409A applies to U.S. citizens and U.S. resident aliens working abroad (who are taxed on their worldwide income) and nonresident aliens working in the U.S. who receive U.S.-source income.

Which Arrangements Are Covered? Compensation arrangements are generally subject to 409A if they provide for the “deferral of compensation,” which occurs when the service provider has a legally binding right to compensation earned in one year that is paid in a later year (*e.g.*, bonuses, nonqualified retirement). There are several exemptions from 409A that may apply and should be reviewed and analyzed with the assistance of legal counsel:

- a foreign plan where contributions to the plan are excluded from U.S. taxation pursuant to a bilateral tax treaty with the U.S.;
- a foreign plan to the extent that compensation earned under the plan would have been excluded from U.S. taxation under a treaty provision if it had been paid to the service provider at the time the right to compensation arose or became vested;
- certain broad-based foreign retirement plans;
- certain funded plans and separation pay plans;
- certain tax equalization agreements;
- foreign social security benefits that are covered under a totalization agreement with the U.S. or are provided under a

government-mandated social security plan;

- amounts that qualify for the foreign earned income exclusion and compensation earned in certain U.S. possessions and territories if paid at the time the amounts are earned, or if later, vested;
- certain limited deferrals by a nonresident alien under a foreign plan; and
- amounts earned by a nonresident alien for services rendered outside of the U.S. that would not have been subject to U.S. taxation if paid at the time the amounts are earned, or if later, vested.

In addition, the exemptions under 409A that are available to U.S. compensation arrangements are also available for foreign arrangements. For example:

- payments that must be made within two and one-half months after the later of the calendar or fiscal year in which a payment is no longer subject to a substantial risk of forfeiture are exempt from 409A under the short-term deferral exemption; and
- stock options and stock appreciation rights are exempt from 409 A if, among other things, the underlying stock is common stock of the company that is the service recipient or its parent, the exercise price is at least equal to the fair market value (determined in accordance with 409A) of the stock underlying the option on the grant date and no other deferral features are present.

Special Transition Rule For In-Bound Service Providers. If a service provider who was not previously subject to 409A becomes a U.S. resident alien, he or she is given a limited transition period to meet the time and form of payment requirements of 409A with respect to any nonqualified deferred compensation plan covering that service provider. The service provider must elect (or be deemed to have elected) by the end of his or her first taxable year in which he or she is a U.S. resident alien: (i) to defer nonqualified deferred compensation payable for services performed during that first taxable year or (ii) to defer nonqualified deferred compensation payable for services performed in a prior year but still subject to a substantial risk of forfeiture (generally, not yet "vested") as of the first day of that first taxable year. The service provider's deferral election, however, may not apply to compensation that has already been paid or made available to the service provider before the election is made. For example, a service provider who becomes a U.S. resident alien in 2011 has until the end of 2011 to make a deferral election for nonqualified deferred compensation earned during 2011 and for nonqualified deferred compensation that was unvested as of January 1, 2011, but the election can only relate to amounts paid or made available after the election is made.

Given the complexity of 409A and the significant sanctions that apply to employees and service providers if a compensatory arrangement does not comply with 409A, employees and service providers who are U.S. citizens or U.S. resident aliens working abroad or non-citizens working in the U.S., and the companies to whom they provide services, should review their compensation arrangements and evaluate whether these arrangements are subject to 409A or fit within an exemption. If the arrangement is subject to 409A and an exemption does not apply, immediate steps should be taken to amend the arrangement to comply with 409A.

With a team of attorneys who are highly experienced in the employee benefits field, MLA can provide answers to questions and assistance in complying with these requirements.