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Another Unexpected Surprise for International Assignees: Section 457A (No, Not 409A!) of the U.S. Tax Code

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By now, most lawyers advising international companies on compensation packages for expatriates that include deferred compensation are familiar with section 409A of the United States Internal Revenue Code ("US tax code" or "Code"). That provision of the Code, as has been stated and restated, imposes complicated restrictions, with heavy penalties for non-compliance, on untimely elections to defer payments of deferred compensation, the circumstances under which deferred compensation is paid out, and, in certain situations, the extent to which deferred compensation can be paid on an accelerated basis.

However, the lesser known Code section 457A creates new complexity, applicable where deferred compensation, including many types of equity compensation, is earned by U.S. taxpayers who perform services for certain non-U.S. corporations and partnerships located in a jurisdiction that is tax indifferent (or more colloquially, a tax haven). In general, if section 457A applies, the period that compensation may be excluded from a U.S. taxpayer's taxable income is limited to no more than 12 months after any service-based vesting condition is satisfied. If a vesting period is based on performance (rather than on the passage of time), the income exclusion may be longer than 12 months, but the amount is subject to an additional 20% tax when paid.

These rules may affect compensation earned not only by U.S. citizens, but also by nonresident aliens with existing deferred compensation who become U.S. tax residents (*i.e.*, green card holders).

Compensation packages for expatriates frequently include some form of deferred compensation – that is, compensation promised in the current year but paid in a future year. Under the U.S. tax code, if properly structured, such amounts are excludable from taxable income in the current year and not taxed until the amounts are paid. Common examples include compensation subject to a vesting schedule and paid at a later date, or paid in the form of annual installments extending beyond the date or dates of vesting.

In recent years, the U.S. tax code broadened the definition of "deferred compensation" to include arrangements traditionally not thought of as deferred compensation, such as certain stock-based awards[1] and severance packages.

Code section 457A is applicable with respect to any non-U.S. corporation or partnership that is a "nonqualified entity." For purposes of Code section 457A, a nonqualified entity is (a) a foreign corporation if less than substantially all of its income (i) is effectively connected with a U.S. trade or business (at least 80% must be so connected) or (ii) is subject to a "comprehensive foreign income tax," or (b) any partnership (either U.S. or foreign) if generally more than 20% of its income is allocated to persons who are (i) foreign persons whose income is not subject to a "comprehensive foreign income tax" or (ii) U.S. tax-exempt organizations. A rationale for these rules is to limit the degree to which income can be deferred when the income is derived from countries that provide tax advantages to their tax residents that are not present in the U.S.

Unexpected (and unpleasant) tax consequences can result under section 457A when a U.S. taxpayer participates in a deferred compensation arrangement while performing services for a non-U.S. employer in a "tax indifferent" jurisdiction, such as Hong Kong, Bermuda, the Netherlands Antilles, much of the Middle East and parts of South America. The U.S. Internal Revenue Service has no plans to designate a definitive list of "tax indifferent jurisdictions," so careful examination is necessary to know exactly which jurisdictions are covered. Section 457A requires a determination each year based on all the facts and circumstances as to whether U.S. taxpayer-employees abroad are subject to its tax consequences.

In short, section 457A requires U.S. taxpayer-employees to recognize income for U.S. tax purposes at the time of vesting, or shortly thereafter, and pay taxes at that time even though the compensation is not payable until a future date. For purposes of these rules, "tax indifferent" jurisdictions are those countries which lack a comprehensive income tax treaty with the U.S. or do not otherwise maintain a comprehensive income tax structure.

> Example 1: A U.S. company with subsidiaries in multiple foreign jurisdictions, including Hong Kong, provides a global restricted stock unit plan. The plan provides that, after grant, 20% of the restricted stock units vest each year, with all units paid out at the end of year five. Generally, the company's U.S. taxpayer-employees around the world are not taxed on the restricted stock units until such units are paid out. However, because Hong Kong is considered a "tax indifferent" jurisdiction, a U.S. taxpayer-employee performing services at the Hong Kong subsidiary must recognize income at the time of vesting – that is, a tax liability arises at the annual vesting dates, not later when the amounts are actually paid.
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> Example 2: Suppose a U.S. taxpayer works in the U.S. headquarters in year 1, in the Hong Kong subsidiary in years 2, 3 and 4, and then returns to the U.S. headquarters in year 5. Because of Hong Kong's tax structure, the units vesting in years 2, 3 and 4 are taxable to the employee at the time of vesting (even though no amount is then paid out), while the units vesting in years 1 and 3 are treated as taxable income only when paid. Depending on any tax equalization agreement in effect, these tax consequences may fall on the company. The complex tax rules referenced in these examples may result in a trap for the unwary if the company fails to withhold and the employee fails to pay tax timely with respect to employment in Hong Kong.

Although generally a foreign corporation will be a nonqualified entity under Code section 457A only if it is resident in a country that is not a party to a comprehensive income tax treaty with the U.S. or does not otherwise have a comprehensive foreign income tax, it is possible that other corporate entities will be subject to these rules. For instance, even if the foreign corporation is located in a treaty country (or a country with a comprehensive foreign income tax), the corporation may still be treated as a nonqualified entity (so that Code section 457A applies) if the foreign corporation receives a significant amount of tax exempt income, including dividends from lower-tier affiliates resident in "tax indifferent" jurisdictions. Therefore, in examining whether section 457A applies to a corporate entity, there must be some analysis of the sources of all of its income.

The analysis of Code section 457A's application is complicated, and at the extreme requires an annual examination of the ownership structure of each foreign corporation involved and the tax status of each assignee.

Consider the following:

In the example above, suppose the U.S. company's location in Hong Kong is a division of a U.S. entity rather than a corporate subsidiary. Code section 457A may not apply because the compensation is being paid by a U.S. division.

If a U.S. taxpayer performs services at a U.K. facility that is a division of a Bermuda subsidiary of a U.S. corporation, Code section 457A may apply.

If a U.S. taxpayer performs services at the Chinese subsidiary of a U.S. corporation, Code section 457A may apply, regardless of a treaty or comprehensive foreign income tax, if China has granted a "tax holiday" as an incentive for the U.S. corporation to locate its subsidiary in China.

Little guidance has been issued with respect to the application of Code section 457A, even though the provision became effective in 2009.[2] The rules are only briefly outlined here.

What A Company Should Do

First, review all global deferred compensation arrangements as soon as possible to determine whether they constitute "deferred compensation" for purposes of Code section 457A.

Second, examine the corporate structure of the company's foreign entities to determine whether any U.S. taxpayers-employees are performing services for nonqualified entities.

Finally, review section 457A's provisions to determine if any prior violations have occurred and make any plan amendments necessary to avoid the effect of Code section 457A.

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[1] Certain stock appreciation rights, non-statutory stock options, and incentive stock options are not subject to section 457A.

[2] I.R.S. Notice 2009-8 (Jan. 8, 2009).