

Morgan Lewis

409A Basics | A Webinar Series

International Issues 409A/457A

Presenters:

Daniel L. Hogans

Zaitun Poonja

Heather C. Brookfield

International Application of Section 409A

- **U.S. Taxpayers**
- Section 409A applies to deferred compensation regardless of the country in which the compensation is earned, unless an exemption applies.
 - U.S. taxpayers = U.S. citizens, legal permanent residents (i.e., green-card holders), and temporary residents
- **Nonresident Aliens**
- Deferred compensation is subject to 409A only if the services are performed in the United States

Exemptions from 409A for Foreign Deferred Compensation Arrangements

- **Tax equalization agreements**
 - If payments are made by the end of the second calendar year that begins after the year in which a U.S. income tax return must be filed for the year to which the tax equalization payment relates.
- **Certain foreign separation pay plans**
 - If the separation pay is required to be paid under the applicable law of the foreign jurisdiction and it only applies to foreign-earned income from sources within that jurisdiction.
 - Applicable to voluntary and involuntary separations.

Exemptions from 409A for Foreign Deferred Compensation Arrangements

- **Broad-based foreign retirement plans**
 - Exemption applies if the plan is nondiscriminatory as to the provision of benefits, 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.
 - For U.S. citizens and resident aliens who are not residents of a U.S. possession, exemption applies if, in addition to the above:
 - *the contributions are nonelective;*
 - *the contributions are made from modified foreign earned income;*
 - *the limits applicable to U.S. plans under Internal Revenue Code (IRC) Section 415 are not exceeded; and*
 - *the individual is not eligible to participate in a U.S. qualified plan.*

Exemptions from 409A for Foreign Deferred Compensation Arrangements

- **Plans covered by an applicable treaty**
 - If contributions to the plan are excludable for federal income tax purposes pursuant to a bilateral income tax treaty to which the United States is a party.
- **Foreign social security systems**
 - If covered under a totalization agreement between the United States and the foreign jurisdiction, or
 - If the contributions are made to a government-mandated social security system.

Exemptions from 409A for Foreign Deferred Compensation Arrangements

- **Compensation deferred by a nonresident alien**
 - If the compensation would not have been subject to U.S. income tax if it had been paid to the nonresident alien at the later of when:
 - *the legally binding right to the compensation first arose, or*
 - *the legally binding right was no longer subject to a substantial risk of forfeiture (SROF).*

What Compliance Steps Should Companies Take?

- Identify all foreign employees who are U.S. taxpayers.
- Identify all foreign benefit arrangements applicable to U.S. taxpayers that could provide for deferred compensation.
- Determine whether an exemption applies to the foreign deferred compensation arrangement.
- If no exemption applies, ensure that the arrangement is 409A compliant.

IRC Section 457A

- Imposes unfavorable tax treatment on U.S. taxpayers deferring income under a nonqualified deferred compensation plan of a nonqualified entity.
 - taxation occurs when SROF lapses
 - If amount of deferred compensation is not determinable at the time the SROF lapses, taxation, plus interest and an additional 20% tax, occurs when the amount becomes determinable.
 - *Amounts will not be “determinable” if they are based on factors that remain variable at the time that the SROF lapses.*

What Constitutes a 457A SROF?

- SROF = Right to compensation generally is conditioned upon a requirement that a service provider perform substantial services.
 - does not include attainment of performance goals
- Definition is applicable for all purposes under 457A:
 - when amounts are includible in income
 - whether amounts constitute short-term deferrals

What Constitutes 457A Nonqualified Deferred Compensation?

- Generally consistent with the 409A definition
 - 457A may include certain cash-settled SARs that are otherwise exempt from 409A
- Short-term deferrals excluded:
 - amounts paid within 12 months after the end of the taxable year of the service recipient during which the SROF lapses
 - exception is based on the 457A definition of SROF (which generally excludes performance goals)

What Entities Are Nonqualified Entities?

- **Foreign corporations**

Exceptions:

- Substantially all of the foreign corporation's income is effectively connected with the conduct of a trade or business in the United States; or
- Substantially all of its income is subject to a comprehensive foreign income tax.
 - *Generally exists where a foreign country (other than Bermuda or the Netherlands Antilles) has entered into an income tax treaty with the United States and the foreign corporation is not subject to a more favorable tax regime in its country of residence than the otherwise imposed U.S. corporate income tax regime.*

- **U.S. and foreign partnerships**

Exception:

- Substantially all of the partnership's income is allocated to persons subject to U.S. tax or comprehensive income tax on the partnership income.

Potential Application of 457A

- **Offshore Hedge Funds**
 - Legislation targeted fee-deferral arrangements employed by offshore hedge funds.
- **Countries without income tax treaties with the United States**
 - U.S. expatriate employees of multinationals working in countries or jurisdictions that do not have comprehensive income tax treaties with the United States.
- **Certain Partnerships**
 - U.S. employees working for partnerships, the partners of which include foreign entities.

Relevant Differences Between Sections 409A and 457A

- **Negative Tax Consequences**

- Section 409A permits compensation to be deferred beyond the vesting date as long as the deferral arrangement complies with the regulations.
- Taxation occurs under 457A when SROF lapses. A service provider subject to 457A will be subject to a 20% penalty tax and underpayment penalty to the extent the amount of compensation is not determinable at the time that the SROF lapses.

Relevant Differences Between Sections 409A and 457A

- **Different definitions of short-term deferral**
 - 409A = compensation that is always paid out within 2 ½ months after the end of the taxable year of the service provider or service recipient, if later, in which the amount is no longer subject to an SROF.
 - 457A = compensation that is paid not later than 12 months after the end of the service recipient's taxable year in which the amount is no longer subject to an SROF.

Relevant Differences Between Sections 409A and 457A

- **Different definitions of SROF**
 - 409A definition includes attainment of performance goals, in addition to performance of services.
- **Payor of compensation**
 - Section 409A applies to compensation paid by any entity; Section 457 applies only to compensation paid by a nonqualified entity.
- **Exempt equity awards**
 - Certain cash-settled SARS that are exempt from 409A may be covered by Section 457A.

Relevant Differences Between Sections 409A and 457A

- **Type of Taxpayer**
 - Section 409A applies only to cash-method service providers; Section 457A applies to both cash- and accrual-method taxpayers.

Case Study #1

- Performance share unit (PSU) program of multinational with early retirement feature that provides for “continued vesting”
- Potentially subject to 457A?
- Covers U.S. taxpayers?
- Employed by nonqualified entities?
- Practical considerations – dealing with accelerated U.S. taxes

Case Study #2

- UK-based London business organized as pass-through entity sponsors long-term bonus program where service requirements for vesting lapse several years before scheduled payment date.
- Is employer a nonqualified entity?
- Who are the “partners” and where and how are they taxed?
- Are participants U.S. taxpayers?
- What if amount is not determinable when service requirements lapse?



Questions?

Contact Information

- Daniel L. Hogans
 - 202.739.5510
 - *dhogans@morganlewis.com*
- Zaitun Poonja
 - 650.843.7540
 - *zpoonja@morganlewis.com*
- Heather C. Brookfield
 - 415.442.1023
 - *hbrookfield@morganlewis.com*

DISCLAIMER

- This communication is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship.
- **IRS Circular 230 Disclosure**
To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend, please see <http://www.morganlewis.com/circular230>.



international presence

Beijing Boston Brussels Chicago Dallas Frankfurt Harrisburg Houston Irvine
London Los Angeles Miami New York Palo Alto Paris Philadelphia Pittsburgh
Princeton San Francisco Tokyo Washington Wilmington