409A and Multinational Employers

409A—Extraterritorial Effect

- Applies to US employees working abroad
  - US citizens and resident aliens who are taxed on their world-wide income
- Applies to foreign employees working in the US
  - Non-citizens who become US residents
    - Based on physical presence test
  - Non-residents with respect to US source compensation
- Exceptions provided in 409A Final Regulations

General Exclusions

Bilateral Tax Treaties

- Plans are not considered “deferred compensation plans” to the extent they are excluded by treaty.
- Final regulations clarify that this exclusion applies to all amounts that would otherwise be treated as income, including employee and employer contributions, allocations, accruals and earnings.
- Payments under a plan are also excluded from 409A to the extent they would be excluded from US taxable income by treaty.
General Exclusions

Social Security Benefits
• Excluded if benefits are covered under a totalization agreement with the US intended to coordinate Social Security benefits.
• Excluded if benefits are provided under a government-mandated Social Security plan.

General Exclusions

Plans Treated as “Qualified”
• Exclude plans funded by foreign-sited trusts that would otherwise meet the requirements of Section 501(a) and are tax-exempt under 402(d).
• Exclude Puerto Rico qualified plans if the plans made a 1022(i) election to comply with ERISA.

General Exclusions

Stock Rights
• Exemption for Options and SARs applies to foreign plans:
  • Exercise price may never be less than the fair market value of the underlying stock as of the date of grant.
  • If the stock is readily tradable on an established securities market, “fair market value” is generally the mean of the high and low trading prices or the closing price on the trading day on or prior to grant.
General Exclusions

Stock Rights
• Final regulation clarify that employers may elect to use an average selling price for this purpose instead:
  • Employer must irrevocably commit to using average selling price before the beginning of the averaging period.
  • Employer must designate the award recipient, number and class of shares subject to the stock right and the method of determining the exercise price (including the averaging period) prior to the beginning of the averaging period.
  • Averaging period must be within 30 days before or 30 days after the valuation date.
  • If foreign law requires use of an averaging method (e.g., France, Netherlands), the requirement to specify the terms in advance will be treated as having been met, as long as the averaging period does not exceed 30 days.

General Exclusions

De Minimis Deferrals
• Deferrals by nonresident alien excluded if made under a “foreign plan”:
  • “Foreign plan” means plan that, aggregated with all substantially similar plans, is maintained primarily for nonresident aliens.
  • Final regulations cap this exclusion at the 402(g) limit (currently, $15,500), as adjusted for the cost of living. (Temporary regulations imposed a fixed $10,000 cap.)
  • To the extent a deferral exceeds the 402(g) limit, the final regulations clarify that a portion up to the 402(d) limit will still be excluded from 409A.

General Exclusions

Other Excludible Income
• US tax-exempt compensation of employees of foreign governments and international organizations for services performed in their official capacity.
• US tax-exempt income sourced from US possessions in Puerto Rico, Guam, American Samoa and the Northern Mariana Islands.
General Exclusions

Earnings
• Earnings on amounts that are not treated as deferrals of compensation by virtue of being deferred under a foreign plan will be excluded.

Other
• The Service has reserved the right to exclude deferrals under other foreign arrangements by means of a revenue ruling.

US Expat (Outbound) 409A Issues

Covered by Non-US Deferred Compensation Plan
• General Rule—US taxpayers are subject to 409A
  • US citizens and green card holders
• Exception—Compensation subject to arrangement excludible from US taxable income under IRC section 911 exclusion
  • Applies to US citizens and resident aliens where certain conditions are met
  • $80,000 annual exclusion of foreign earned income, including current compensation
  • Availability of exclusion is determined at later of accrual or vesting of the deferred compensation
  • Also excludes earnings on excluded deferrals

EXAMPLE:

US citizen transferred to the UK subsidiary of US multinational and is covered by UK nonqualified deferred compensation arrangement.
Participation in Broad-based Foreign Plans Covering US Citizens and Residents

- Scheme, trust, arrangement or plan in writing provided
  - Nondiscriminatory—eligibility to make or receive contributions or accrue benefits is available to wide range of employees, substantially all of whom are non-resident aliens or bona fide residents of a possession
  - Plan actually provides significant benefits for a substantial majority of covered employees
  - Benefits provided are nondiscriminatory
  - Plan generally discourages use of benefits for other than retirement or restricts access during employment

Conditions for exemption

- Not eligible to participate in US “qualified” plan
- Deferral is non-elective and relates to modified foreign earned income
- Annual deferral is limited to not more than section 415 limits
- Special Rules for Green Card holders
  - Exception applies only to plan (or portion of plan if allocable) providing for non-elective deferrals of “modified foreign earned income” and earnings on such non-elective deferrals
  - “Modified foreign earned income” is foreign earned income under section 911 without regard to exclusion for deferred compensation and requirements relating to citizenship, US residency and presence or residence in foreign country

Tax Equalization Agreements

- US employee/citizen working abroad with agreement to be made whole for additional cost of dual taxation
- Final Regulations provide exemption if payment made by latest of:
  - end of second tax year beginning after tax year in which employee’s US income tax return is required to be filed for tax year to which payment relates; or
  - end of second year beginning after the latest tax year in which employee’s foreign tax return is required to be filed for the year to which payment relates
### US Expat (Outbound) Issues

Foreign Separation Pay Plans or Termination Indemnity Plans
- Available for involuntary or voluntary separations
- Foreign law must require payments
- Covers only foreign earned income from sources within the foreign country requiring separation pay subject to additional conditions

### Foreign Expat (Inbound) 409A Issues

Foreign nationals generally subject to US tax on income from services performed in the US
- Foreign nationals generally subject to US tax on world-wide income once they become US residents
  - Based on physical presence test
  - Based on lawful permanent residence ("green card") test
  - Timing rules

Statutory overrides
- Employees of foreign government and international organizations
- Possible treaty overrides
  - Foreign national has closer connection to foreign country and limited presence in US
  - "Pension" and "annuity" income

### Foreign Expat (Inbound) 409A Issues

No general exceptions under section 409A for individuals who are not US nationals
- Treasury Department and IRS specifically rejected suggestions to adopt broad exceptions for:
  - Plans granted favorable tax treatment under laws of foreign jurisdictions
  - Amounts deferred by nonresident aliens providing only temporary services in US
  - Employee stock purchase plans of foreign employers that do not meet requirements of section 423
  - Amounts deferred by US nationals working for foreign employers
- Nevertheless, many of these arrangements exempt under narrower exceptions provided in regulations
### Foreign Expat (Inbound) 409A Issues

Exception for deferred compensation that would not have been subject to US tax if received on later of accrual or vesting
- Not subject to US tax based on tax treaty
- Not subject to US tax because individual was nonresident alien and compensation was not for services in US
- Not subject to US tax because individual was employee of foreign government or international organization
- Not subject to US tax because compensation was derived from sources within a US possession

Earnings on exempt amounts also covered by exception
- Definition of earnings

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### Foreign Expat (Inbound) 409A Issues

Exception for participation in broad-based foreign plans covering resident and nonresident aliens (described elsewhere)
- Following special rules do not apply in case of participation by nonresident aliens, aliens classified as resident aliens based on physical presence test (and not “green card” test), and bona fide residents of US possessions
  - Limitation to nonelective deferrals of “modified foreign earned income”
  - Section 415 limits
  - Requirement that individual not be eligible to participate in a US tax-qualified plan

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### Foreign Expat (Inbound) 409A Issues

Exception for tax equalization payments
- Identical to exception for US expats, except that payments compensate individual for excess of US taxes over taxes that would be imposed if amounts subject to tax solely in foreign jurisdiction

Exception for de minimis deferrals under foreign plans (described elsewhere)
Exception for foreign separation pay plans (described elsewhere)
Exception for foreign social security systems subject to totalization agreements with US and other government-mandated foreign social security systems (described elsewhere)
### Foreign Expat (Inbound) 409A Issues

#### Other exceptions
- Other, general exceptions under statute and regulations might also be available
- Regulations authorize IRS to create exceptions for other plans in revenue procedures and other published guidance

#### Grace period to bring deferred compensation plans into compliance when individual becomes resident alien
- Rule applies to compensation for services performed in, and compensation subject to a substantial risk of forfeiture on the first day of, the first taxable year in which individual is a resident alien
- Definition of substantial risk of forfeiture and application to elective deferrals
- Rule deems plan to comply with initial deferral election requirements if deferral election is made by end of such first taxable year
- Does not apply to amounts paid or made available before election is made
- Rule deems plan to comply with time and form of payment requirements if plan is amended by end of such first taxable year
- Grace period may be available again in future year if individual has not been classified as resident alien for three consecutive taxable years
- Rule does not apply to deferrals of compensation for services performed in US, but other exceptions might apply
- Other administrative issues

#### Definitional issues
- Exceptions and special rules with respect to the definition of “nonresident alien” under section 409A
- Six-month delay for payments to “specified employees” of public companies applies regardless of whether company is foreign or stock is traded on foreign securities market
- However, there is special rule for when nonresident aliens are taken into account in identifying “specified employees"
Offshore Trusts

Assets transferred to a trust outside the US to pay for deferred compensation are subject to 409A, even if the trust would not otherwise be taxable under Section 83 (e.g., a “rabbi” trust).

- Last year, the IRS issued Notice 2006-33, which provided relief for amounts transferred to an offshore trust on or prior to March 21, 2006 if the plan trust comes into compliance on or before December 31, 2007.
- The notice did not provide relief for amounts transferred or set aside in an offshore trust after March 21, 2006.
- The final regulations provide that taxpayers should continue to rely on Notice 2006-33 until the Service issues further guidance.

Aggregation

If foreign earned income is not exempt, for purposes of determining 409A penalty, foreign plans may be aggregated separately from domestic plans if:

- Deferrals of foreign earned income are paid to the employee at the time the amount is first deferred;
- Substantially all participants in the plan and any substantially similar arrangements are nonresident aliens; and
- Employee does not participate in substantially identical domestic arrangement.

409A Seminar Series Archive

Archive of Sessions 1 through 4
- Available online at www.pillsburylaw.com
- Select “Events” then “Past Events: 2007”
- Presentations, handouts, worksheets and audio
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