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Employee Benefits & Executive Compensation

Multinational and Non-US Companies Need to Address Compliance with US Code Section 409A

We recently distributed a client alert relating to the January 1, 2009, deadline for compliance with the final regulations issued under Section 409A of the US Internal Revenue Code (the "Code"), governing nonqualified deferred compensation arrangements. (See "Section 409A Deadline Ahead: Current Action Required.") This alert is intended to remind our multinational and non-US clients that the application of Code Section 409A does not stop at the "water's edge" and may reach non-US deferred compensation programs and arrangements in which US citizens and resident aliens in non-US countries, and foreign citizens in the US, participate. It also outlines certain action items that we believe such companies should consider taking prior to December 31, 2008.

Background

Section 409A imposes significant requirements on deferred compensation for employees and other service providers, such as directors and independent contractors. The definition of "deferred compensation" subject to Section 409A includes not only traditional deferred compensation plans, but also many types of arrangements (or aspects of arrangements) that typically have not been considered deferred compensation, such as employment agreements, severance plans, certain equity-based compensation, certain bonus arrangements, fringe benefit arrangements, expense reimbursement arrangements, indemnification arrangements, change in control agreements, and tax gross-up arrangements.

In brief summary, Section 409A requires that: (i) elections to defer compensation be made within certain specified annual deadlines; (ii) the time and form of distribution of deferred compensation meet specific and detailed requirements; and (iii) in the case of publicly held corporations, distributions to certain "key employees" on account of separation from service be delayed six months.

The failure of a deferred compensation arrangement to meet these requirements results in the immediate taxation of a participant's vested accrued benefit (even if those benefits have not yet been distributed to him) and the imposition of a 20 percent additional income tax and interest. There may be additional state income taxes in the case of state tax codes that "piggyback" on the federal tax code. Section 409A also imposes on employers new reporting and withholding requirements with respect to amounts subject to Section 409A.

Although Section 409A became effective January 1, 2005, the IRS provided a lengthy good faith compliance transition period and a delayed amendment deadline. The good faith transition period expires at the end of 2008. By January 1, 2009, all nonqualified deferred compensation plans must be amended and in full operational compliance with Section 409A, the final regulations and all other applicable guidance thereunder.

While the penalties resulting from noncompliance generally fall on the individual, it is our experience that

most companies , for employee relations reasons, want to avoid causing their employees and other service providers to become subject to such penalties. In addition, in some instances, individuals who become subject to the penalties may look to their employer to make them whole for such penalties on the grounds that compliance with the new requirements is generally in the employer's control. Unfortunately, not all employers are aware of the extensive reach of Code Section 409A, particularly with respect to its application to non-US arrangements.

Non-US Arrangements

As noted above, the application of Section 409A does not stop at the US border; employees otherwise subject to US income tax laws are not exempt from Section 409A merely because they work outside of the United States. Because US citizens and resident aliens are subject to US taxation on their worldwide income, their participation in "foreign" plans is subject to Section 409A, unless an exception applies. In addition, nonresident aliens working even for limited periods in the United States, with US source income in excess of certain thresholds, may also be subject to Section 409A even if covered only by "foreign" plans in their home country.

Final regulations issued by the IRS contain a number of exemptions from Section 409A that will, in many cases, be helpful to multinational and non-US employers. These include: plans and compensation exempt under bilateral tax treaties; certain broad-based non-US retirement plans; certain non-US separation pay plans; non-US social security arrangements; certain tax equalization agreements; elective deferrals of non-resident aliens up to certain thresholds; deferrals of compensation exempt from taxation under the US Internal Revenue Code; and amounts that are otherwise taxable under certain other Internal Revenue Code Sections. In addition to the exemptions specific to non-US programs, certain other exemptions contained in the regulations may be useful. For example, an exception for "short term deferral arrangements" will cause many bonus arrangements to escape the requirements of Section 409A, and an exception for certain severance plans with limited benefits paid over limited periods of time will cause many severance programs for rank and file employees to fall outside of Section 409A.

The exact parameters of these exemptions, particularly those potentially applicable to non-US arrangements, are detailed and complex and, in some cases, apply somewhat differently to the different categories of employees who may be subject to Section 409A. By way of example, a program that meets the specific regulatory definition of a "broad-based non-US retirement plan" in the regulations is completely exempt as it applies to nonresident aliens and certain resident aliens, even with US source income, but is exempt on a more limited basis with respect to US citizens and lawful permanent residents. Moreover, the exemptions, in the aggregate, do not exempt all non-US arrangements; there are a number of gaps in coverage. For example, assume a US citizen works in a non-US country for a non-US corporation and becomes a participant in the company's unfunded supplemental retirement plan that is maintained for high-paid executives only (and that is not comparable to any other plan maintained by the employer). Absent an applicable treaty exemption, the individual's accruals under the plan will be subject to Section 409A. If the plan does not contain all of the provisions required by that Code Section, or is not operated in accordance with such provisions, the individual will suffer the draconian tax consequences of Section 409A. Similarly, if the individual is granted options to purchase stock in the non-US parent and the exercise price has not been determined in a manner that complies with the final regulations, that individual's stock

options will be subject to Section 409A (and will in most cases violate Section 409A on account of not having a fixed date of exercise.)

Overall, an analysis of the effect of Section 409A on the benefits of US citizens and resident aliens working abroad, and on those of non-US citizens working in the US, requires (i) appropriate classification of the status of such individuals and their sources of income, (ii) identification of the types of arrangements in which the individuals participate, and (iii) an analysis of the applicability of one or more of the exceptions from Code Section 409A to each such arrangement, including exclusion by treaty or statute.

Thus, in addition to bringing their US plans, if any, into compliance with Section 409A, multinational and non-US employers should take steps to identify any non-US arrangements that could fall within the definition of "deferred compensation" under Section 409A, determine whether participants in such arrangements may include any US citizens or resident aliens, or any nonresident aliens with US source income, identify any exceptions from Section 409A that apply to such arrangements and take steps to bring those that are not excepted from Section 409A into compliance therewith. Such steps include not only operational changes, but also adoption of amendments to the arrangements no later than December 31, 2008.

More Information

This client alert is not intended to be a comprehensive summary of all issues relating to Section 409A as it applies to non-US plans. If you have any questions regarding the information in this Alert or its applicability to your circumstances, please contact the member of our Employee Benefits & Executive Compensation practice who regularly advises you, or one of the lawyers listed below. That lawyer can also provide copies of other memoranda prepared by Mayer Brown LLP relating to Section 409A.

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