

**New US Tax Rules for  
Nonqualified Deferred  
Compensation –  
Overview for Non-US Employers**  
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## Overview of Presentation

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## Background – Law and Existing and Anticipated Guidance

- **American Jobs Creation Act of 2004 added Section 409A, which contains rules for nonqualified deferred compensation plans, to the Internal Revenue Code**
- **IRS interim and proposed guidance**
  - **Notice 2005-1 (December 20, 2004)**
  - **Proposed regulations (September 29, 2005)**
  - **Other issue-specific notices**
- **Comprehensive final guidance has not yet been issued**
  - **Expected Summer 2006 or later in 2006**

## Background – Consequences

- **Adverse tax consequences for failure to comply:**
  - Deferred amount is subject to ordinary income tax
  - Additional 20 percent income tax on amount required to be included in income under 409A
  - Interest may be assessed on tax underpayments in certain circumstances
- **Tax liability is imposed on the “service provider” (employee) – not on the “service recipient” (employer)**
  - Employers do have withholding and reporting obligations

## Plans Subject to 409A – Definition of Deferred Compensation

- **Nonqualified deferred compensation plans**
- **Broadly defined – any plan or arrangement that provides for a deferral of compensation**
- **Plan provides for the deferral of compensation if**
  - a) **employee has a legally binding right during a taxable year to compensation that has not been actually or constructively received,**
  - b) **employee has not included compensation in gross income, and**
  - c) **the compensation will not be payable until a later year**
- **No legally binding right if employer has unfettered discretion to reduce or eliminate compensation, unless the negative discretion lacks substantive significance or can only be exercised upon a condition**

## Plans Subject to 409A – Definition of Deferred Compensation (cont.)

- **409A applies to individual agreements as well as broad-based plans**
  - **Example:** Severance provisions in an employment agreement may be deferred compensation
- **409A not limited to employer/employee relationships**
  - 409A applies to employees, outside directors, some independent contractors and personal service corporations
  - Exception for accrual method service providers

## Plans Subject to 409A – Amounts Not Treated As Deferred Compensation

- **Certain Tax-Qualified Plans and Welfare Plans**
  - US Tax-Qualified plans
  - Compensatory time
  - Vacation leave
  - Disability pay
  - Sick leave
  - Death benefits
- **Certain Equity Compensation**
  - Incentive stock options (ISOs)
  - FMV Nonqualified options
  - Restricted stock
  - US tax-qualified employee stock purchase plans
  - FMV stock appreciation rights (SARs)
- **Certain Severance Pay Arrangements**
- **Partnership Interests, including profits interests**
- **Short-Term Deferrals**
  - Compensation paid within 2½ months of the end of the first taxable year in which it is no longer subject to a substantial risk of forfeiture
  - Potential examples: multi-year bonuses, restricted stock units, severance

## Effective Date of 409A; Grandfathered Amounts

- **409A applies to:**
  - **Compensation deferred in taxable years beginning after December 31, 2004, and**
  - **Compensation deferred in taxable years beginning before January 1, 2005, if the underlying plan is “materially modified” after October 3, 2004**
- **Compensation that is earned and vested (i.e., no longer subject to a substantial risk or forfeiture) as of December 31, 2004 is not subject to 409A (so long as plan is not materially modified)**
- **Earnings on grandfathered amounts are not subject to 409A**

## Good Faith Compliance With 409A Through End of 2006

- **Nonqualified deferred compensation plans that are not grandfathered must be:**
  - **Operated in good faith compliance with 409A at all times**
  - **Amended to comply with 409A by December 31, 2006**
  - **Put in writing by December 31, 2006**
- **Taxpayers may rely on either proposed regulations or Notice 2005-1 until final regulations are effective**

## Initial Deferral Elections – General Rule

- **Deferral election must specify the time and form of payment**
- **If employee has no election, plan must specify time and form of payment when employee has a legally binding right to payment**
- **Deferral elections generally must be made by the end of the tax year preceding the year in which the compensation is earned**
  - **For example, elections for compensation earned in 2007 must be made by December 31, 2006**

## Initial Deferral Elections – Exceptions to General Rule

### ▪ Initial Participation

- A deferral election may be made within 30 days after an employee is initially eligible to participate in a certain type of deferred compensation plan, if the election only applies to compensation for services performed after the election
- Types of plans – account balance, non-account balance, involuntary termination and window program separation pay arrangements and other arrangements

**Example:** If an employee who participates in an existing account balance plan becomes newly eligible to participate in another account balance plan of the same employer, that employee could not use this exception to make a mid-year deferral election upon eligibility for the other plan

## Initial Deferral Elections – Exceptions to General Rule (cont.)

- **Unvested Compensation**

- “13 Month Rule” – Election may be made on or before the 30th day after the employee obtains a legally binding right to compensation subject to a substantial risk of forfeiture, if the election is made at least 12 months in advance of the earliest date at which the forfeiture condition could lapse.  
*E.g.*, RSUs and long-term bonuses

- **Performance Based Compensation**

- If performance-based compensation (defined in 409A guidance) is based on services performed over a period of at least 12 months, a deferral election may be made until six months before the end of the performance period (but performance criteria must not be substantially certain to be met at the time of the election)

## Initial Deferral Elections – Exceptions to General Rule (cont.)

- **Separation Pay Arrangements**
  - Separation pay that is negotiated at arms-length when an employee involuntarily separates from service can be deferred if the deferral election is made on or before the date when the employee obtains a legally binding right to that separation pay
- **Grace period for new US resident aliens**
  - At any time during the first calendar year in which an individual is classified as a US resident alien, that individual can make an initial deferral election as to compensation earned in that year, or as to compensation that is unvested as of January 1 of that year, as long as that deferral election is made before the amounts of compensation to be deferred are paid or payable

## Subsequent Changes in the Time and Form of Payment

- On or prior to December 31, 2006, employees may change prior deferral elections, including accelerating payment, without violating 409A
  - Exception: No elections in 2006 that would accelerate payment into 2006 or defer amounts otherwise payable in 2006
- After December 31, 2006, the time and form of payment for a prior deferral election cannot be changed unless:
  - a) the change does not take effect for 12 months,
  - b) the payment is deferred for at least five years from the prior payment date (other than payments due to death, disability or unforeseeable emergency), and
  - c) in the case of payments at a specified time or pursuant to a fixed schedule, the change is made at least 12 months before the date of the first scheduled payment

## Prohibition on Acceleration of Payments

- **After December 31, 2006, acceleration of the time or schedule of any payment under a deferred compensation arrangement is not permitted**
  - Exceptions:** Compliance with a divorce decree
  - Unforeseeable emergency
  - Payment of US social security taxes, and related income tax withholding, on deferrals

## Permissible Payment Events

- **Separation from Service**
- **Death or “Disability” as defined in 409A**
- **Specified Time or Pursuant to a Fixed Schedule**
  - Includes payment of previously unvested compensation upon the occurrence of an objectively determinable vesting event
- **“Change in Control” as defined in 409A**
- **“Unforeseeable Emergency” as defined in 409A**

## Permissible Payment Events (cont.)

- **Payments are not permitted if a permissible payment event has not occurred**
- **Payments can be made upon the earliest or latest to occur of more than one of these permissible payment events**
- **Amounts payable in the first calendar year in which an employee becomes a US resident alien, and any subsequent year, are deemed to satisfy these permissible payment event rules as long as the plan is amended (if necessary) as to that employee by December 31 of that first year so that the times and forms of payment of amounts payable in subsequent years comply with these permissible payment event rules**

## 6-Month Delay in Payments to Key Employees of Public Corporations

- **Payments upon separation from service (other than due to death) to “key employees” of publicly-traded corporations must be delayed for at least six months after the date of separation**
- **Key employees: generally, the 50 top-paid officers with annual compensation over \$140,000 (for 2006)**

## Off-shore “Rabbi” Trust Penalties

- **US beneficiaries of vested nonqualified deferred compensation will be taxed (and subject to additional 20% income tax and potential interest) under 409A when assets are funded to a related “rabbi” trust or other arrangement that is located outside the US**
  - Exception:** if substantially all of the services to which the deferred compensation relates are performed where the assets are located
- **Transition rule: assets held in a trust or other arrangement outside the US on March 21, 2006 will not trigger a violation of 409A as long as those assets are moved to the US by December 31, 2007**
  - **No transition relief for contributions to an off-shore “rabbi” trust after March 21, 2006**

## Off-shore "Rabbi" Trust Penalties (cont.)

- **409A does not apply to assets contributed to a trust or other arrangement (whether or not located in the US) that is secure from claims of the employer's creditors**
  - **Under existing US tax laws, beneficiaries of the trust will be taxed as soon as their interests in the trust or other arrangement vest**

## Non-US Plans and Foreign Source Income – No General Exemption From 409A

- **No rule generally exempts non-US plans or foreign source income from 409A coverage**
- **However, the proposed regulations provide a number of specific exceptions from the scope of 409A for non-US plans and compensation earned outside the US**

## Non-US Plans and Foreign Source Income – Exceptions From 409A for Non-US Citizens or Residents

- **Compensation that would not have been subject to US tax if it had been paid to the employee when the legally binding right to the compensation first arose, or, if later, when vested, and the employee was a nonresident alien at such time**
- **Contributions excludable from US tax pursuant to a tax treaty with the US**
- **Participation in certain broad-based foreign retirement plans**
- **Participation in governmental social security systems subject to totalization agreements with the US and similar plans**
- **Compensation earned in the US and deferred under a non-US plan if those deferrals do not exceed \$10,000 for the year (however, proposed regs may be read to mean that the \$10,000 limit applies to deferred amounts **plus** non-deferred compensation for services performed in the US)**

## Non-US Plans and Foreign Source Income – Exceptions From 409A for US Citizens or Residents Working Abroad

- **Participation in certain broad-based foreign retirement plans exempt from 409A if:**
  - **Employee not eligible to participate in US tax-qualified or tax advantaged retirement plan**
  - **Deferrals are not elective**
  - **Deferrals consist solely of foreign earned income**
  - **Amount deferred does not exceed the amount of contributions or benefits that could be provided under a US tax-qualified retirement plan**

## Non-US Plans and Foreign Source Income – Exceptions From 409A for US Citizens or Residents Working Abroad (cont.)

- **Tax equalization payments made within 2 years after the year in which the employee's US tax return is required to be filed for the year to which the payment relates**
- **Participation in governmental social security systems subject to totalization agreements with the US and similar plans**
- **Deferred compensation of a US citizen or resident working abroad that:**
  - **constitutes foreign earned income and**
  - **together with that individual's other foreign earned income, is less than \$80,000 (2006)**

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