Section 409A and Deferred Compensation Arrangements for U.S. Expatriates and Inpatriates

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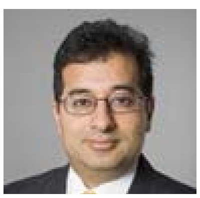

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This practice note addresses how I.R.C. § 409A and the regulations thereunder, which govern nonqualified deferred compensation (Section 409A), apply to deferred compensation of U.S. taxpayers who work or have previously worked outside the United States. It outlines foreign plan and other exemptions from Section 409A that may apply to such taxpayers and practical approaches for compliance with the rules in cases where an exemption does not apply. It also describes the consequences of noncompliance with Section 409A. Finally, the practice note provides a brief overview of similar, but even more restrictive, deferred compensation rules under I.R.C. § 457A (Section 457A), which becomes relevant if a U.S. taxpayer participates in a deferred compensation arrangement sponsored by a so-called nonqualified entity. Such Section 457A considerations arise when a U.S. taxpayer provides services to an entity established in a jurisdiction outside of the United States where it is not subject to a comprehensive income tax regime, and is therefore often relevant for entities established in tax haven jurisdictions, but also apply in other circumstances. For purposes of this practice note, the term expatriates refers to U.S. citizens and other U.S. tax residents performing services outside the United States, and the term inpatriates refers to nonresident aliens who transfer into, and perform services within, the United States.

The practice note is organized under the following topics:

- Section 409A Overview
- Common Exceptions Relevant to Expatriates and Inpatriates
- Section 911 Foreign Earned Income Exclusion for Certain Expatriates
- Additional Exemptions and Special Rules for Inpatriates
- Approaches When No Special Exception Applies
- Other Considerations: Foreign Stock Rights Plans and Section 457A
- Nonqualified Deferred Compensation Assessment Checklist for Expatriates and Inpatriates

Section 409A Overview

Section 409A, which generally became effective in 2005, imposes rules that apply where a service provider (employee or nonemployee) acquires a legally binding right during a taxable year to compensation that, pursuant to the terms of the arrangement, is or may be payable in a later year. Certain plans are not subject to Section 409A, including tax-qualified employer plans, bona fide sick leave or vacation plans, disability plans, death benefit plans, and certain medical expense reimbursement arrangements.

Any compensation that is covered by Section 409A is referred to as nonqualified deferred compensation, and all arrangements providing for nonqualified deferred compensation are referred to as nonqualified deferred compensation plans, regardless of the actual form of the document establishing the legally binding right.

Section 409A's definition of nonqualified deferred compensation appears simple, but in practice it is extremely broad, with the result that it applies to many compensation arrangements that were not traditionally viewed as providing a deferral of compensation, such as severance benefits,retention or incentive bonus agreements, or other compensation arrangements with delayed payment terms.

Basic compliance requirements for Section 409A are discussed later in this practice note, under Approaches When No Special Exception Applies. For additional information on Section 409A, see Section 409A Fundamentals.

Who Is Subject to Section 409A?

Section 409A applies to anyone subject to U.S. federal income taxation who receives nonqualified deferred compensation, including (1) U.S. tax residents and (2) nonresidents of the United States who earn U.S.-source compensation.

U.S. Tax Residents

U.S. tax residents include the following individuals:

1. U.S. citizens
2. U.S. permanent residents, also known as green card holders
3. Individuals who are tax resident in the U.S. based on meeting a substantial presence test (unless an exemption applies), which requires spending at least 31 days in the relevant tax year and more than 182 days over a three-year period in the United States (calculated using the following formula: (1 x days in current year) + (1/3 x days in first preceding year) + (1/6 days in second preceding year) –and–
4. Nonresident alien individuals who do not qualify as resident aliens under either category (2) or (3) above in the year of their arrival in the United States, but will do so in the following year under the substantial presence test, and who elect to be taxed as a resident alien in the year in which they arrive in the United States

See I.R.C. § 7701(b) (residency rules).

The United States taxes its tax residents on a worldwide basis, regardless of whether they are working within or outside the United States, although relief may be available in some cases for work outside the United States. As a result, Section 409A fully applies to U.S. citizens and other U.S. tax residents who participate in nonqualified deferred compensation arrangements while working as expatriates outside the United States and after they return to the United States, unless a special exception applies.

Inpatriates frequently become U.S. tax residents, either under the substantial presence test or as a result of acquiring a green card, after a period of employment in the United States.

Nonresidents Earning U.S.-Source Income

Section 409A also applies to nonresident aliens who perform services and earn nonqualified deferred compensation in the United States (U.S.-source income). Any such U.S.-source income is subject to U.S. tax, with limited exceptions under tax treaties and the I.R.C. for certain short-term U.S. assignments and de minimis amounts of earnings. Section 409A will also be relevant for nonresident aliens who transfer to the United States and thereafter continue their participation in foreign nonqualified deferred compensation arrangements, as well as to any deferred compensation arrangements in which they may participate while working in the United States.

Consequences of Noncompliance with Section 409A

The following sections describe the potential consequences of Section 409A noncompliance generally and special considerations for expatriates and inpatriates.

Penalties and Interest

If a covered deferred compensation arrangement fails to comply with Section 409A, severe adverse tax consequences may arise for the service provider. Specifically, all amounts deferred under the noncompliant nonqualified deferred compensation plan are includible in gross income from the tax year in which they ceased to be subject to a substantial risk of forfeiture (i.e., from vesting), to the extent not previously included in income. In addition, such deferred amounts are subject to an additional 20% federal income tax and a premium interest tax determined at a rate equal to the IRS underpayment rate plus 1% on the deemed underpayment of tax for amounts deferred that should have been included in income in the year in which deferred or, if later, when they ceased to be subject to a substantial risk of forfeiture.

States may have adopted similar tax penalty provisions. For example, California imposes an additional 5% state tax, interest, and penalties on amounts that do not comply with Section 409A.

Employer Withholding Obligation

Although the service provider bears the penalties and premium interest that result from a violation of Section 409A, if there is an employment relationship, the employer is required to withhold tax on income arising from a violation of Section 409A as if the amounts were received in the year of the violation. These amounts also have to be reported as wages on Form W-2 and identified as noncompliant deferred compensation by reporting in box 12 of Form W-2 using Code Z. Amounts included in income are treated as supplemental wages for purposes of determining the amount of tax to be withheld regardless of whether the employer paid other wages to the employee during the calendar year. I.R.S. Notice 2008-113, 2008-2 C.B. 1367.

The withholding obligation does not apply to the additional 20% tax or interest penalties imposed by Section 409A, but the employee will be required to pay these amounts upon filing of his or her tax return, the application of the penalty being flagged for the IRS by the Code Z reporting on the participant's Form W-2.

Although not themselves subject to penalties, companies that provide compensation that is not in compliance with Section 409A often feel a duty to assist employees in paying any tax liabilities that arise as a result of such noncompliance. As any payment of tax on behalf of an employee will need to be provided on a grossed-up basis to capture taxes payable on the tax borne by the employer, a Section 409A failure that an employer decides to cover can become very costly, particularly when it impacts a large number of employees.

Plan Aggregation Rules

The punitive nature of Section 409A's penalties is heightened by its plan aggregation rules, under which all plans of a similar type maintained by the same employer in which a service provider participates must be aggregated when determining compliance with Section 409A and calculating penalties. 26 C.F.R. § 1.409A-1(c)(2). In other words, a violation under one plan of a particular type results in potential penalties applicable to all amounts deferred by the employee under that plan and other employer plans of the same type. An exception for documentary noncompliance is noted further below.

The Section 409A regulations identify nine types of nonqualified deferred compensation plan, including:

- Elective account balance plans
- Non-elective account balance plans
- Non-account balance plans (defined benefit plans)
- Separation pay plans that pay only on an involuntary separation from service or pursuant to a window program
- Reimbursement or in-kind benefit plans
- Split-dollar life insurance arrangements
- Foreign plans, with respect to deferrals of certain foreign source income, under which substantially all the participants are nonresident aliens and for service providers who do not participate in substantially similar domestic arrangements
- Stock rights (i.e., stock options and stock appreciation rights) that are subject to Section 409A (most are designed to be exempt) –and–
- Plans or arrangements not falling into one of the preceding categories

For this purpose, note that an exception to the plan aggregation rules applies to a violation that relates solely to a failure to meet Section 409A's written plan document requirements. Such a violation will not be considered to apply to all other deferrals of compensation under other plans of the same type that meet the Section 409A requirements. 26 C.F.R. § 1.409A-1(c)(3)(vii).

Special Considerations for Expatriates and Inpatriates

For U.S. expatriates and inpatriates, the tax consequences of noncompliance with Section 409A may be even more severe than for other U.S. taxpayers. This is because noncompliance with Section 409A means that deferred compensation will be subject to taxation in the U.S. upon vesting, which may be substantially earlier than the timing of taxation in the applicable foreign jurisdiction in which the expatriate or inpatriate is, or has been, providing services. In most cases, by design, the relevant deferred compensation will not be subject to foreign taxation until it is paid, which may be many years after the time of vesting.

Such mismatch in the timing of the U.S. and non-U.S. taxable events can make it more difficult for the expatriate or inpatriate to claim a foreign tax credit under national law or the terms of an applicable tax treaty for income that is subject to taxation in both jurisdictions. In some cases, a credit will no longer be available, resulting in double U.S. and foreign taxation on income that has already been subject to Section 409A's substantial penalties.

Common Exceptions Relevant to Expatriates and Inpatriates

The treasury regulations under Section 409A provide a number of exclusions or exemptions for nonqualified deferred compensation arising under foreign plans and are potentially helpful for U.S. expatriates and/or inpatriates. Although most of the special foreign plan exceptions are applicable to both expatriates and inpatriates, they apply in slightly different ways. Thus, the following sections discuss these special rules separately for expatriates and inpatriates where distinctions are helpful.

Tax Treaty Exclusion

The Section 409A regulations provide an exclusion for income that is excluded from U.S. federal income tax pursuant to a tax treaty to which the United States is a party. This exclusion applies to employer and employee contributions, allocations, accruals, and earnings to a plan, scheme, trust, or arrangement, to the extent that such income is exempt from federal tax under any such tax treaty. 26 C.F.R. § 1.409A-1(a)(3)(i).

Inpatriate Considerations for Tax Treaty Exclusion

The tax treaty exclusion will typically enable an inpatriate from a treaty country to continue participating in a foreign pension plan while working in the United States, without amounts contributed, allocated, accrued, or earned under the foreign plan being subject to Section 409A.

Specific requirements may vary depending on the terms of the applicable treaty. However, both the new U.S. Model Income Tax Convention, released by the Treasury Department in February 2016, and its predecessor from 2006, provide a potential exclusion from U.S. taxation for benefits accrued under and contributions paid by or on behalf of a U.S. inpatriate to a pension plan established in the relevant treaty country. The U.S. Model Income Tax Convention sets forth the baseline text the Treasury Department uses when it negotiates tax treaties and its position on this issue is reflected in terms of treaties with several countries, including the United Kingdom. Unfortunately, few U.S. income tax treaties in effect contain the current Model Income Tax Convention language on pension plans. For more information on the 2016 U.S. Model Income Tax Convention and links to U.S. tax treaties currently in force, see the Treasury Department website.

Under the U.S. Model Income Tax Convention, the Section 409A tax treaty-based exclusion will apply if:

- The inpatriate began participating in the pension plan before commencing employment in the United States –and–
- The IRS has agreed that the foreign pension plan generally corresponds to a U.S. qualified plan

The exclusion is limited to the extent that tax relief is available for U.S. residents for benefits under a U.S. pension plan. In other words, for the exception to apply, the foreign pension plan would need to be largely equivalent to a U.S. qualified plan, such as a 401(k) plan or other qualified plan under I.R.C. § 401(a). The amount excludible from treatment as nonqualified deferred compensation is limited to the amount that would be excludible from current U.S. taxation under a corresponding U.S. qualified plan. As a result, there is a degree of overlap between this exclusion and that available for broad-based foreign retirement plans, as discussed below.

Expatriate Considerations for Tax Treaty Exclusion

This same 409A exemption is also potentially available to expatriates. In the few cases where the applicable treaty contains the Model Income Tax Convention language on pensions, Section 409A's treaty provisions may provide a limited exclusion from Section 409A. This exclusion applies for contributions, allocations, accruals, and earnings relating to a foreign tax-qualified pension plan that is generally equivalent to a U.S. qualified retirement plan, up to the amount excludible from current U.S. taxation under the applicable U.S. qualified plan. For example, the benefits under the U.S./U.K. treaty apply only to the extent that the contributions or benefits qualify for tax relief in the United Kingdom and do not exceed the amounts eligible for tax relief under a generally corresponding U.S. pension plan, such as a 401(k) plan, other qualified plan under Section 401(a) of the Code, or certain other plans provided for under the Code.

This exclusion may be useful to the extent that a U.S. expatriate participates in a foreign employer's tax-qualified pension plan while working outside the United States, particularly if the expatriate is at the same time eligible to participate in a U.S. qualified plan and therefore could not rely on the broad-based foreign retirement plan exclusion, discussed below. However, it will not apply to any income under a **nonqualified** pension plan or other nonqualified deferred compensation arrangement under which a U.S. expatriate may accumulate significantly larger amounts of income.

Although there is generally a concern regarding U.S. taxpayers claiming treaty benefits to reduce U.S. income taxation as a result of the "savings clause" generally included in U.S. tax treaties, an exception is available in this situation. Such savings clauses preserve the right of each contracting country to tax its residents as if no tax treaty existed. However, in the limited number of treaties that include the pension plan income provision, the provision is specifically listed as an exception to the savings clause. For example, the 2016 U.S. Model Income Tax Convention provides an exception to the savings clause for pension distributions and contributions to, and benefits accrued under, a foreign pension plan while a U.S. person is exercising employment in the applicable treaty party foreign country.

Broad-Based Foreign Retirement Plan Exclusion

The Section 409A regulations state that a broad-based foreign retirement plan (defined below) is not a nonqualified deferred compensation plan, thereby excluding any such plan from taxation under Section 409A. This means that U.S. taxpayers may participate in qualifying foreign retirement plans without Section 409A consequences. In general, the exclusion applies to foreign retirement plans that cover a broad group of mostly nonresident employees and provide significant benefits for such employees on a nondiscriminatory basis. 26 C.F.R. §§ 1.409A-1(a)(3)(ii), -1(a)(3)(v).

Specifically, a broad-based foreign retirement plan means a written plan that meets all of the following requirements:

- The plan is nondiscriminatory, such that a wide range of employees (including rank-and-file employees) are eligible to participate, substantially all of whom are nonresident aliens, residents of the U.S. under the substantial presence test (but not the green card test), or residents of a U.S. possession (e.g., Guam, Puerto Rico).
- The plan (alone or in combination with other comparable plans) actually provides significant benefits for a substantial majority of such covered employees.
- The benefits actually provided under the plan to such covered employees are nondiscriminatory.
- The plan contains provisions or is subject to tax laws or other legal restrictions that generally discourage employees from using plan benefits for purposes other than retirement or restrict access to plan benefits before separation from service, including restrictions on in-service distributions.

Notwithstanding the "foreign" nomenclature, the exclusion may apply to a plan regardless of whether the plan is sponsored by a foreign or U.S. employer. Further, although the exclusion requires that the plan be nondiscriminatory, the regulations do not require application of the more robust nondiscrimination rules that must be used to test U.S. qualified plans.

Inpatriate Considerations for Foreign Retirement Plan Exclusion

The broad-based foreign retirement plan exclusion has more utility for inpatriates than for expatriates because no additional conditions, over and above the four requirements outlined above, apply for an inpatriate to utilize the exception. Specifically, individuals who are nonresident aliens, as well as individuals who are residents of the U.S. under the substantial presence test (but not the green card test), and bona fide residents of U.S. possessions, may continue participating in a broad-based foreign retirement plan after moving to the U.S. without incurring liability under Section 409A for amounts deferred under the plan.

Expatriate Considerations for Foreign Retirement Plan Exclusion

Although the broad-based foreign retirement plan exclusion is probably the most useful of the Section 409A provisions applicable to foreign plans, because its requirements are more onerous for U.S. citizens and permanent residents than for other U.S. taxpayers, its helpfulness for expatriates is reduced.

Specifically, for U.S. citizens and permanent residents, the broad-based foreign retirement plan exclusion from Section 409A is available only to the extent that the plan meets the above four requirements and all of the following additional conditions:

1. The individual has deferred "modified foreign earned income" under the plan on a nonelective basis (e.g., through employer contributions).
2. The amounts deferred under the plan and other plans of the employer in the tax year do not exceed the annual limit for (as applicable) a defined benefit plan under Code Section 415(b) ($225,000 for 2019) or a defined contribution plan under Code Section 415(c) ($56,000 for 2019).
3. The individual must not be eligible in the same year to participate in a U.S. qualified retirement plan.

With regard to condition (1) above:

- If the foreign plan allows for both nonelective and elective deferrals, the exception for the nonelective deferrals is allowed only if the nonelective deferrals are segregated and distinct from the elective deferral amounts.
- The "modified foreign earned income" to which the exclusion applies consists of income earned in a foreign country without regard to whether the individual was resident or present in the foreign country for the time period normally required to exclude a certain amount of foreign earned income from U.S. federal tax under I.R.C. § 911 (up to $105,900 for 2019). The purpose of this modification to the Section 911 definition of foreign

earned income is to allow the exception from Section 409A to apply to a U.S. citizen or permanent resident who works overseas during only part of a year, or is otherwise on a short-term assignment abroad.

Where its requirements can be met, the broad-based foreign retirement plan exemption will shield income earned under a foreign unfunded plan by a U.S. expatriate from potential penalties under Section 409A. However, as counsel to the employer, you will need to remain mindful of its various conditions on an ongoing basis, including that the exclusion applies only up to the annual limit under I.R.C. § 415(b) or (c), depending on whether the foreign plan is a defined benefit plan or a defined contribution plan.

Plans Subject to a Totalization Agreement and Similar Plans

Section 409A does not apply to contributions made to or compensation received under a foreign social security system to the extent that benefits are provided under a government-mandated plan or pursuant to a plan covered by a totalization agreement A totalization agreement is an international social security agreement entered into between the United States and the foreign jurisdiction under Section 233 of the Social Security Act (42 U.S.C. § 433) for the purpose of eliminating dual social security taxation and addressing potential gaps in benefit protection for workers who have divided their careers between the United States and another country. To date, the U.S. has Totalization Agreements with 28 countries. 26 C.F.R. § 1.409A-1(a)(3)(iv).

For further discussion and summaries of current U.S. totalization agreements, see Rhoades & Langer, U.S. Int'l Tax'n & Tax Treaties § 74.00. Additional information and full text documents are available on the U.S. Social Security International Social Security Agreements website.

Inpatriate Considerations for Totalization Arrangement Exclusion

A key effect of totalization agreements is that inpatriates to the U.S. from totalization agreement countries may remain subject to the social security system of their home countries while working in the United States. Under the terms of the existing U.S. totalization agreements, such continued participation in a foreign social security system is generally possible only when an inpatriate is on an assignment in the United States with an expected duration of five years or less, and subject to the inpatriate's obtaining of a certificate of coverage from the social security authorities in his or her home country. In such circumstances, the exception from Section 409A for compensation under a foreign social system allows the inpatriate to contribute to, and/or receive benefits under, that foreign system without concern as to whether any such deferrals of compensation or receipt of deferred compensation implicate Section 409A.

Expatriate Considerations for Totalization Arrangement Exclusion

For expatriates, the foreign social security system exclusion means that any compensation that a U.S. taxpayer earns under a government-mandated plan in a foreign country or from a foreign social security system in a country with which the U.S. has a totalization agreement will not be subject to Section 409A.

This Section 409A exclusion may be helpful for certain expatriates, particularly those on long-term or indefinite assignments in foreign countries, given that a U.S. person working in a totalization agreement country on an assignment expected to last more than five years will generally be subject to that country's social security system.

Funded Plan Exclusion

If a U.S. taxpayer participates in a foreign retirement or deferred compensation plan that is funded, so as to protect the assets in the plan from the sponsoring company's creditors, then amounts paid to the taxpayer under that plan will not be subject to Section 409A. This is because, in accordance with I.R.C. §§ 402(b), 402(c), and 83, amounts contributed to a funded trust or similar arrangement are subject to federal taxation when such amounts become vested. 26 C.F.R. § 1.409A-1(b)(6). Section 402(b) and Section 402(c) of the Internal Revenue Code relate, respectively, to the transfer of a beneficial interest in a trust or annuity plan, and Section 83 relates to the transfer of property as compensation for services, such as in the case of a restricted stock award.

In other words, Section 409A and its related penalties do not apply where a U.S. taxpayer, whether an expatriate or an inpatriate, vests in contributions under a foreign plan that is funded, which may be the case for many foreign deferred compensation and retirement plans. However, the U.S. taxpayer owes current U.S. tax on such vested amounts, even if such amounts are not paid until termination of service or retirement under the terms of the foreign plan. Therefore, as counsel to the employer, you should still tread carefully when analyzing the tax consequences of U.S. taxpayer participation in foreign funded plans.

An important consideration in this regard is that the employee may be required to pay tax to the foreign country upon distribution from the plan (not when the amount vests as under U.S. tax rules). This means that income earned under the foreign funded plan may be taxed twice but at different times, and affected taxpayers may not be eligible to claim a foreign tax credit to offset such double U.S. and foreign taxation due to the timing mismatch. (This is similar to the issue outlined above in the discussion of Section 409A noncompliance under the section entitled “Special Considerations for Expatriates and Inpatriates.”)

Exemption for Tax Equalization Payments

To ease the potential tax burden of internationally mobile employees and to encourage employees to take business-necessary international assignments, most multinational employers have a tax equalization policy, at least for certain employees (e.g., executive-level employees). These policies aim to make the international employment assignment tax neutral for the assignee.

Under a typical equalization policy, tax-equalized employees will pay approximately the same amount of income and social security taxes that they would have paid had they remained in their home jurisdiction, generally through withholding by the employer of a “hypothetical home country tax,” with the employer paying any taxes due in the applicable host jurisdiction, as well as in the home jurisdiction. If the amount of home jurisdiction tax the tax-equalized expatriates actually owe for the year differs from the amount of hypothetical tax withheld, they either receive a refund from the employer of the excess amount withheld or are required to pay an additional amount to the employer.

The treasury regulations under Section 409A provide a specific exemption for tax equalization agreements which will apply to the extent that payments under the agreements do not exceed either (1) the excess of the foreign tax liability over the hypothetical U.S. tax liability, or (2) the excess of the U.S. tax liability over the hypothetical foreign tax liability, plus the applicable gross-ups on the amount described in clause (1) or (2), as applicable. 26 C.F.R. § 1.409A-1(b)(8)(iii).

Payments made under a qualifying tax equalization arrangement will be exempt from Section 409A provided they are made by the later of:

- The end of the second year beginning after the tax year in which the individual’s U.S. income tax return (including extensions) is required to be filed for the year to which the payment relates –or–
- The end of the second year beginning after the latest tax year in which the individual’s foreign income tax return is required to be filed for the year to which the payment relates

This deadline is generally more favorable than deadlines for other payments specified in the 409A regulations (e.g., general gross-up payments, which are discussed below in the discussion for expatriates).

Tax equalization payments made following the resolution of an audit, litigation, or similar proceeding are also exempt from Section 409A if the payments are made by the end of the year following the individual’s tax year in which the individual remits the related taxes.

Inpatriate Considerations for Equalization Payment Exemption

The exemption for tax equalization payments generally is sufficient for non-U.S. employees assigned to work in the United States, given that they are usually no longer subject to a continuing foreign tax liability. In other words, they would generally be fully tax-equalized if their employer paid them an amount equal to the amount of extra taxes imposed by the U.S. over the foreign taxes that would have applied if the compensation were solely subject to home country taxation, plus the amount necessary to compensate for the additional taxes due on the tax equalization payment itself (including gross-ups).

Expatriate Considerations for Equalization Payment Exemption

In contrast to the situation for inpatriates, the Section 409A definition of tax equalization agreement is typically not sufficiently broad for the method frequently used for tax equalization of U.S. expatriate employees. This is because in limiting qualifying tax equalization payments to the excess of the foreign tax liability over the hypothetical U.S. tax liability, the exemption does not apply to additional amounts frequently paid by U.S. employers to U.S. expatriates to compensate them for additional **U.S.** taxes they incur as a result of the assignment (due to their remaining subject to U.S. federal tax on their worldwide income). In regard to this group, the employer will generally pay the excess of all taxes—foreign **and** U.S.—over the hypothetical U.S. tax liability.

As a result, the exemption for tax equalization agreements would not exclude all of the equalization payments made by a U.S. employer that uses a comprehensive tax equalization approach for U.S. expatriates. In those cases, the payments that do not qualify for the tax equalization agreement exemption may be made in a manner to comply with Section 409A if the payments meet the requirements set forth for tax gross-up payments in general under 26 C.F.R. § 1.409A-3(i)(1)(v). Under these rules, as counsel to the employer, you must make sure the employer makes the relevant tax equalization payments to the expatriate employee by the end of the year following the individual’s taxable year in which the individual remits the related taxes. In addition, to comply with

Section 409A's documentation requirements, you must make sure this deadline is explicit in the tax equalization agreement or policy document evidencing the arrangement.

Section 911 Foreign Earned Income Exclusion for Certain Expatriates

Section 911 of the Internal Revenue Code (Section 911) allows a qualifying U.S. expatriate to exclude certain foreign earned income from gross income. This exclusion does not apply to inpatriates. The maximum amount of foreign earned income that can be excluded is indexed to inflation ($105,900 for 2019). To avail of the exclusion, the expatriate must:

- Have his or her tax home in a foreign country –and–
- Be either:
  - A U.S. citizen who is a bona fide resident of a foreign country for an entire taxable year –or–
  - A U.S. citizen or resident who, during any period of 12 consecutive months, is present in a foreign country or countries for at least 330 full days

I.R.C. § 911(d)(1).

An individual's tax home will generally be in the country in which he or she has a regular or principal place of business, or, if there is none, then his or her place of abode in a real and substantial sense. I.R.C. § 911(d)(3).

Section 409A does not apply to foreign earned income that is excluded from U.S. taxation, including under the Section 911 foreign earned income exclusion. 26 C.F.R. § 1.409A-1(b)(1). As a result, expatriates who earn less than the Section 911 threshold for a particular year while working in a foreign jurisdiction are able to defer the remainder of their foreign earned compensation up to the applicable annual threshold without needing to comply with Section 409A.

Further, the treasury regulations under Section 409A include provisions that continue to protect any such foreign earned income deferred by an expatriate within Section 911's maximum exclusion amount even if the income is paid at a later time when the individual no longer qualifies for the exclusion (e.g., if the income is paid to the expatriate after he or she returns to the United States). This continued exclusion from Section 409A is available for deferred amounts paid to an expatriate (or former expatriate) provided that the expatriate would have been eligible to exclude the deferred foreign earned income from U.S. taxation under Section 911 if it had been paid at the time it was earned, or if later, at the time it vested. 26 C.F.R. § 1.409A-1(b)(8)(ii)(B).

In other words, as long as the expatriate would have been eligible for the Section 911 exclusion when the compensation was earned or vested, the fact that it is paid at a later time when the expatriate is no longer eligible for the exclusion does not preclude the expatriate from continuing to treat such deferred foreign earned income as exempt from Section 409A.

The Section 911 exclusion itself, combined with Section 409A's exception for deferred foreign earned income that is paid even after the Section 911 exclusion no longer applies, may provide a valuable tax planning device for expatriates who are not highly paid and who plan to return to the United States following their international assignment.

Additional Exemptions and Special Rules for Inpatriates

In addition to the special rules discussed above that apply to both expatriates and inpatriates (other than the Section 911 exclusion applicable only for certain expatriates), the following sections describe some additional rules that may be helpful for individuals coming to the United States on work assignments.

Previously Vested Compensation

A particularly useful exemption to Section 409A allows an inpatriate to the United States to receive payment of deferred compensation that was earned in a prior year for services outside the United States without regard to whether the original deferred compensation arrangement complied with Section 409A, provided that the inpatriate was nonresident when the right to the compensation arose, or if later, vested (within the meaning of Section 409A). For Section 409A purposes, vesting occurs when the deferred amount is no longer subject to a substantial risk of forfeiture, as defined in 26 C.F.R. § 1.409-1(d).

This exemption for previously vested compensation applies in a few different circumstances under the regulations, as outlined below.

Section 872-Based Exemption for Vested Compensation

One strand of the exemption applies where the individual:

- Receives payment of deferred compensation that would not have been includible in the individual's gross income under I.R.C. § 872 (Section 872) had it been paid at the time the individual first obtained a legally binding right to the compensation, or if later, upon vesting –and–

- Was a nonresident alien at the time such right was obtained, or if later, vested

26 C.F.R. § 1.409A-1(b)(8)(ii)(A).

Under Section 872, a nonresident alien is subject to U.S. federal income tax on (1) gross income derived from sources within the U.S. which is not effectively connected with the conduct of a trade or business in the United States (e.g., dividends of a U.S. corporation), and (2) gross income which is effectively connected for the tax year with the conduct of a trade or business in the United States (e.g., compensation for personal services performed in the United States).

Taking the above requirements together, this exemption may apply to employment compensation received by an inpatriate in the United States, even after the time the inpatriate becomes a U.S. tax resident, if the inpatriate was a nonresident alien when he or she obtained the right to, or if later, vested in, the compensation **and** the inpatriate did not earn any of the compensation while working in the U.S.

This generally means that, as counsel to the employer, you will need to confirm that the inpatriate did not previously work in the United States between the grant and vesting of the deferred compensation. However, if the inpatriate did spend some time working in the United States during this period, an exception from the general rule may apply if he or she:

- Was working for and compensated by a foreign employer
- Spent 90 or fewer days in the U.S. in any tax year –and–
- Earned no more than $3,000 during such period

I.R.C. § 861(a)(3).

If this relatively narrow exception to the U.S.-source income rule does not apply, then you should check whether any previously vested compensation of an inpatriate may qualify for the treaty strand of this exemption, discussed in the next section.

Treaty-Based Exemption for Vested Compensation

A Section 409A exemption applies where an individual receives payment of deferred compensation that would not have been includible in the individual's gross income under a U.S. tax treaty or convention had it been paid at the time the individual first obtained a legally binding right to the compensation, or if later, upon vesting. 26 C.F.R. § 1.409A-1(b)(8)(i).

As tax treaties typically come into play only in situations of overlapping or double income taxation, the treaty-based exemption for previously vested compensation will typically be relevant when an inpatriate receives payment of previously vested compensation which was partially earned based on service in the United States, but which is exempt from U.S. taxation under special treaty rules relevant to short-term business visitors. These provisions generally require all of the following conditions are satisfied:

- The treaty country resident has spent a total period of service in the United States not exceeding 183 days.
- The compensation is paid by or on behalf of an employer who isnot a resident of the United States.
- The compensation is not borne by a permanent establishment or fixed base of the employer in the United States.

If an inpatriate qualifies for the benefit of a tax treaty to which the United States is a party, the treaty-based exemption for vested compensation may provide a helpful alternative to the Section 872-based exemption in cases where the inpatriate has previously spent up to six months of the vesting period of deferred compensation working in the United States.

Accelerating Vesting to Avoid Application of Section 409A

The previously vested compensation exemption provides an excellent tax planning opportunity for individuals transferring to the United States because it may be possible to accelerate the vesting of any deferred compensation arrangements that do not comply with Section 409A **before** the transferees become residents of the United States.

For example, it is common for individuals outside the United States to receive equity awards that provide for a deferral of compensation but that do not comply with Section 409A. This includes discounted stock options that are granted with an exercise price lower than the fair market value of the underlying shares at grant (as determined under 26 C.F.R. § 1.409A-1(b)(5)(iv)), and restricted stock units with retirement-vesting or other provisions that result in a deferral of compensation from a U.S. tax perspective, but which are not designed to comply with Section 409A.

To avoid triggering potential tax penalties under Section 409A with respect to compensation that vests or is paid under these awards after the award holder transfers to the United States, it is often possible to accelerate the vesting of the noncompliant equity award so that it is fully vested before the award holder becomes a U.S. tax resident. Payment of the award, through exercise of the option by the award holder or delivery of shares pursuant to the vested restricted stock unit, may then occur after the individual becomes a U.S. tax resident without Section 409A consequences. Note, however, you must make sure to check the terms of the equity plan under which the relevant awards were granted to confirm that it is possible to accelerate vesting and to ascertain any other limitations or procedures that may apply (e.g., board approval or other corporate governance requirements).

Exemption for Foreign Government/ International Organization Employees and Residents of U.S. Possessions

A similar exemption to those discussed in the previous two sections applies to previously vested deferred compensation that would have been excludible from U.S. income under I.R.C. §§ 893 (applicable to foreign employees of foreign governments and international organizations), 931 (applicable to bona fide residents of Guam, American Samoa, or the Northern Mariana Islands), or 933 (applicable to bona fide residents of Puerto Rico). Again, the exemption applies if the deferred amount would have been eligible for the applicable I.R.C. section's exemption if it had been paid when the right to such compensation arose or vested. 26 C.F.R. § 1.409A-1(b)(8)(ii)(C) and (D).

De Minimis Deferrals for Nonresident Inpatriates

Section 409A provides a de minimis exemption for certain limited deferrals of nonresident aliens, which may benefit an inpatriate who works in the United States for a short period of time and does not become a tax resident of the United States.

Under this exemption, nonqualified deferred compensation of a nonresident inpatriate will be exempt from Section 409A to the extent that it does not exceed the deferral limit for elective deferrals under I.R.C. § 402(g) for the applicable year ($19,000 for 2019) (Section 402(g) limit). This de minimis exemption will allow an inpatriate on a temporary U.S. assignment to participate in a foreign deferred compensation plan while working in the United States and to make deferrals under such foreign plan up to the relevant Section 402(g) limit, without Section 409A consequences, including with respect to earnings on such limited deferrals. Any amount deferred in excess of the 402(g) limit would need to comply with Section 409A, unless another exemption is available. 26 C.F.R. § 1.409A-1(b)(8)(iv).

To qualify for this exemption, the foreign plan in which the inpatriate participates, together with all substantially similar plans, must be available to a substantial number of participants, substantially all of whom are nonresident aliens or resident aliens under the substantial presence test (but not the green card test). Id.

This exemption may be useful for purposes of allowing an inpatriate to continue participating in a relatively broad-based foreign deferred compensation plan during a short U.S. assignment, or to receive service or compensation credit for such brief period of U.S. service under the benefit formula of a foreign nonqualified deferred compensation plan, but it is important to bear in mind that it applies only to the extent that the inpatriate is a nonresident. As a general rule of thumb, this means that it is of limited utility to an inpatriate who will spend more than six months in a single tax year in the United States.

Grace Period for New Inpatriates

Another helpful planning tool under the Section 409A regulations gives inpatriates and their employers a limited period of time to bring the inpatriate's pre-existing deferred compensation arrangements into compliance with Section 409A following the inpatriate's arrival in the United States. Although the rule refers to amending such pre-existing arrangements so that the time and form of payment of amounts "comply with" Section 409A, some commentators have suggested that this rule, by implication, also permits amendments to enable the arrangements to be exempt from Section 409A. Given the ambiguity in the rule, amendments to enable Section 409A exemptions, such as the short-term deferral exemption, should be made as soon as possible once the individual becomes subject to U.S. income taxation. For amendments which enable the arrangements to comply with Section 409A, these special grace period rules are available for inpatriates who have previously been classified as resident aliens only if the inpatriate has been a nonresident alien for the prior three consecutive calendar years. 26 C.F.R. § 1.409A-3(h).

Specifically, in the first tax year that an individual becomes a resident alien of the United States, the parties may make any necessary amendments to pre-existing deferred compensation plans until the end of the calendar year in which the inpatriate changes status from a nonresident alien to a resident alien. Note that this change of status may occur after the first year of arrival if the inpatriate does not meet the substantial presence test, acquire a green card, or otherwise elect to be taxed as a resident in the year of arrival.

Further, the grace period rules allow an inpatriate to elect to defer compensation during the first year of residency under an exception to Section 409A's strict rules around the timing of elections to defer compensation. It is normally necessary for any election to defer compensation to be made in the calendar year prior to the year in which the compensation will be earned. However, under the grace period exception, in the first year of residency, it is possible for the inpatriate to make an initial deferral election for compensation payable for services in that first year or that is unvested as of the beginning of that year, subject to the following limitation. Importantly, the deferral election may not apply to any compensation that has already been paid or made available to the inpatriate. 26 C.F.R. § 1.409A-2(c).

Approaches When No Special Exception Applies

Notwithstanding the various exemptions and exclusions from Section 409A that may be available for expatriates and inpatriates, such individuals commonly participate in nonqualified deferred compensation arrangements that do not fit within any of the special rules. For example, a nonqualified deferred compensation plan that is not broad-based or funded and/or in which the individual's level of participation exceeds the limits imposed for a U.S. qualified plan may not qualify for any of the special exemptions for foreign plans. When this occurs, it will be necessary to either adapt the arrangement to qualify for a general exemption to Section 409A or ensure that the arrangement is documented and operated so as to comply with Section 409A.

General Section 409A Exemptions

The general exemptions to Section 409A that are available for U.S. nonqualified deferred compensation plans may also be used for foreign plans and compensation arrangements—primarily, the exclusion for short-term deferrals, discussed below, and the exemption for certain severance pay arrangements, including a special rule for foreign severance plans under 26 C.F.R. § 1.409A(b)(9)(iv) where severance is required to be provided under applicable foreign law. In practice, the short-term deferral exemption is likely to have the broadest application.

Short-Term Deferral Exemption

One of the most important and widely used exemptions to Section 409A is that for arrangements that provide for only a short period between the date that compensation ceases to be subject to a substantial risk of forfeiture and the date that it is paid. 26 C.F.R. § 1.409A-1(b)(4)(i).

Under the short-term deferral rule, a deferred compensation arrangement will be exempt from Section 409A if payment of the compensation must under the terms of the plan be made (and actually is paid) by no later than the 15th day of the third month following the **later** of the end of the service provider's taxable year or the end of the service recipient's taxable year in which the compensation first ceases to be subject to a substantial risk of forfeiture (subject to extension for certain unforeseeable events). For calendar year taxpayers, this means that payment must be made no later than March 15 of the calendar year following the year in which the compensation became vested (i.e., no longer subject to a substantial risk of forfeiture).

For further information on short-term deferrals, see Section 409A Fundamentals and Substantial Risk of Forfeiture under the IRC.

Short-Term Deferral Considerations for Expatriates and Inpatriates

To rely on the short-term deferral rule, it is important to ensure that the terms of the relevant compensation arrangement do not provide for any possibility that payment may occur later than the end of the short-term deferral period. For example, you should be mindful of favorable retirement vesting provisions, under which a retirement-eligible employee may be deemed vested in compensation from a tax perspective in a tax year prior to the year in which the compensation is scheduled to be paid, thereby creating deferred compensation that does not qualify for the short-term deferral exemption.

Because Section 409A does not provide any specific exclusion for common expatriate (or inpatriate) benefits such as housing subsidies, relocation payments, and cost-of-living differentials, it is often necessary to rely on the short-term deferral exemption for payment of such benefits. In many cases, such benefits can satisfy the requirements of the exemption because they are paid currently, provided that continued service by the employee is required to receive payment.

However, even benefits that are intended to be provided on an annual basis may raise Section 409A concerns because the ultimate calculation and settlement of the benefits may not satisfy the short-term deferral exemption. For example, cost-of-living allowances and housing allowances may be based on family size and other factors and there may be a delay in calculating and paying these benefits, such that any retroactive payment may not qualify for the short-term deferral exemption. You should anticipate these problems in advance when designing expatriate policies and agreements so that if a potentially nonexempt deferral of compensation may occur, the documentation is drafted to comply with Section 409A, as discussed below.

Compliance with Section 409A

Where no special or general exemption from Section 409A is available for a nonqualified deferred compensation plan covering an expatriate or inpatriate, it will be necessary to ensure that the plan complies with Section 409A from both a documentary perspective and in operation.

In general, this means that the plan, which may consist of one or more documents, must (1) be in writing, and (2) establish the amount (or an objective, nondiscretionary payment formula) and the time and form (e.g., lump sum or instalments) of payment of any deferred compensation. 26 C.F.R. § 1.409A-1(c)(3). The specified payment event must be one of the following six permissible payment events under Section 409A:

- Separation from service (as defined in 26 C.F.R. § 1.409A-1(h))
- Disability (in accordance with 26 C.F.R. §1.409A-3(i)(4))
- Death
- A time or a fixed schedule specified under the plan
- Change of control (in accordance with 26 C.F.R. §1.409A-3(i)(5) –or–
- Unforeseeable emergency (in accordance with 26 C.F.R. §1.409A-3(i)(3)

26 C.F.R. § 1.409A-3(i).

Any payment due upon separation from service to certain "specified employees" of a publicly traded corporation, must be delayed by an additional six months following separation from service (or until the employee's earlier death). I.R.C. § 409A(a)(2)(B)(i). A public company's specified employees typically consist of its top 50 most highly compensated officers (including officers at companies within its controlled group). Note that a company can elect to exclude certain nonresident aliens (who have no US source income) from the list of specified employees. The six-month delay for specified employees must be included in the written plan document 26 C.F.R. § 1.409A-1(c)(3)(v)). For further discussion on the six-month delay rule, see Section 409A Six-Month Delay Rule Compliance.

Any election to defer compensation on the part of a service provider will also need to be in writing and generally needs to be made no later than the close of the taxable year preceding the year in which the services to which the compensation relates are rendered. I.R.C. § 409A(a)(4); 26 C.F.R. § 1.409A-2. There are exceptions to this timing requirement, including for newly eligible plan participants and for performance-based compensation that meets certain requirements. Any change to a prior deferral election may be made only if in compliance with specific rules governing subsequent deferral elections, including that the subsequent deferral election is made at least 12 months before the scheduled payment date and it defers payment for a minimum of five years from such date. For more information, see Section 409A Deferral Election Chart.

Outside of the subsequent deferral election rules, there is limited ability to make changes to a deferred compensation arrangement that complies with Section 409A because the rules prohibit both acceleration and delay of payments (with certain exceptions in each case). For general information on Section 409A, see Section 409A Fundamentals.

Other Considerations: Foreign Stock Rights Plans and Section 457A

Two other issues that frequently arise in the context of internationally mobile U.S. taxpayers relate to participation in foreign stock option plans and potential exposure under I.R.C. § 457A (Section 457A) when a U.S. taxpayer participates in a nonqualified deferred compensation plan sponsored by a foreign entity.

Foreign Stock Rights Plans

Stock options (and stock appreciation rights) granted to acquire Section 409A "service recipient stock" (generally, common shares of an employer company, or any higher tier subsidiary in the chain of corporate ownership between the employer company and its parent company) are generally exempt from Section 409A provided that they have an exercise price at least equal to the fair market value of the underlying shares at grant and they do not contain any additional deferral feature. 26 C.F.R. § 1.409A-1(b)(5)(i).

Even where discounted options are not permitted by a foreign stock option plan, a problem may arise when the manner in which fair market value is calculated for purposes of pricing options under the plan does not comply with Section 409A's rules for determining fair market value under 26 C.F.R. § 1.409A-1(b)(5)(iv).

For publicly traded companies that price stock options based on the fair market value on the grant date, the Section 409A regulations are flexible in terms of permitting use of the last sale before, or the first sale after, the grant; the closing price on the trading day before, or the trading day of, the grant; the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant; or "any other reasonable method using actual transactions in such stock as reported by such market." 26 C.F.R. § 1.409A-1(b)(5)(iv)(A).

However, the use of an averaging method to determine the fair market value is permitted only where the average selling price is within 30 days before, or 30 days after, the grant date and provided that the issuer company irrevocably specifies the commitment to grant the option with an exercise price set using such an average selling price **before** the beginning of the specified period, including designation of the optionee, the number and class of shares subject to the option, and the method for determining the exercise price. Id.

This means that an option that is priced using an averaging method other than 30 days before or after the grant date, or that is not specified and approved by the issuer company before the relevant period begins, may result in the grant of a discounted option for Section 409A purposes. As it is not uncommon for foreign stock option plans to use an averaging method for determining the exercise price of options, this rule can cause such plans to run afoul of Section 409A, with the result that any U.S. taxpayer optionee may receive an option that may be discounted for U.S. tax purposes and therefore subject to federal tax upon vesting, along with Section 409A's penalties.

For example, French tax-qualified options must be granted with an exercise price at least equal to 80% of the average closing price of the relevant shares during the 20 trading days immediately preceding the grant date. In another example, Belgian law allows companies granting stock options to determine the exercise price using the fair market value of the shares on the date of the offer (i.e., the date the option terms are communicated to optionees) or the average of the stock prices in the 30 days preceding the date of the offer, and companies often elect the latter method. Note that it is not problematic from a Section 409A perspective to use the date of the offer as the determinative date for pricing options, provided that there is not an unreasonable delay between the date of the grant and the date of the offer 26 C.F.R. § 1.409A-1(b)(5)(vi)(B).

An exception exists for foreign stock option plans where applicable foreign law requires that a stock option be priced using a specific price averaging method and period. In this case, a stock option priced in accordance with such applicable foreign law will be treated as complying with Section 409A's pricing requirement as long as the averaging period does not exceed 30 days. 26 C.F.R. § 1.409A-1(b)(5)(iv)(A).

In practice, however, this is a fairly narrow exception because there are few situations where foreign law **requires** an averaging method and does not permit the granting of an option at a price higher than the price determined using such method. For example, options will still be tax-qualified under French law if the exercise price is set using the fair market value on the grant date as long as that price is at least equal to the price determined under its required averaging method. In the case of Belgium, because the company has a choice between using an averaging method and using a spot date method, it is unlikely that Section 409A's exception to meet a "requirement" of foreign law applies.

Therefore, as counsel to the employer: (1) you should be careful about allowing U.S. taxpayers to receive stock options under foreign employer option plans, and consider disallowing such participation entirely; and (2) prior to any transfer of inpatriates to the United States, you should assess whether any options they hold under foreign plans are eligible for the Section 409A stock rights exception (taking into account its special rules for averaging methods required by foreign law), and, if not, consider accelerating the vesting of those options prior to the inpatriates' attainment of U.S. tax residency to avoid Section 409A consequences, as discussed above in the section entitled "Previously Vested Compensation" under Additional Exemptions and Special Rules for Inpatriates.

Potential Exposure under Section 457A

In some situations, Section 457A also needs to be reviewed independently of the Section 409A analysis. The general rule of Section 457A is that a nonqualified deferred compensation arrangement sponsored by a "nonqualified entity" (described below) is includible in taxable income when the deferred amount is no longer subject to a substantial risk of forfeiture (as defined narrowly in Section 457A). If the deferred amount is not determinable at that time, the amount will be subject to tax on the date that the amount first becomes determinable, at which point the tax for the year of income inclusion will be increased by the sum of (1) an additional amount of tax equal to 20% of the amount included in income under Section 457A at that time, plus (2) a premium interest tax factor.

One of the key differences between Section 457A and Section 409A is if the nonqualified deferred compensation is not exempted from Section 457A, it cannot be structured to comply with Section 457A to allow for taxation in a later year. Instead the accelerated income inclusion and additional tax will apply. This is intentional as Congress enacted Section 457A in 2008 with a stated intent of shutting down offshore deferred compensation.

Section 457A Nonqualified Entities

Unlike Section 409A, the service provider/employee must be mapped to a particular legal entity to determine whether Section 457A applies. Essentially, the entity entitled to take a corporate income tax deduction under U.S. principles for the compensation of the employee is considered the sponsor of any nonqualified deferred compensation of the employee. If that entity is determined to be a nonqualified entity under the Section 457A guidance (I.R.S. Notice

2009-8, 2009-1 C.B. 347) in any particular year, then Section 457A will apply to that compensation.

The determination of whether an entity is a nonqualified entity is made as of the last day of the service provider's taxable year in which the nonqualified deferred compensation is no longer subject to a substantial risk of forfeiture. An entity's status as a nonqualified entity may change from year to year.

For this purpose, it is important to review the actual employment structure used by the expatriate or inpatriate, as secondment by or to a U.S. domestic entity may result in a different Section 457A result than the direct employment of the expatriate or inpatriate by a foreign entity, even if the individual is participating in the same deferred compensation plans.

Section 457A guidance provides that a foreign corporation is a nonqualified entity **unless** substantially all of its income is either (1) effectively connected with the conduct of a trade or business in the United States, or (2) subject to a comprehensive foreign income tax. (Although not referenced in this discussion, similar rules apply for partnerships.) I.R.C. § 457A(b).

Substantially all of the foreign corporation's income is subject to a comprehensive income tax if:

- The foreign corporation either:
    - o Is eligible for the benefits of a comprehensive income tax treaty between its country of residence and the United States –or–
    - o Demonstrates that it is resident for tax purposes in a foreign country that has a comprehensive income tax –and–
- The foreign corporation is not taxed by its country of residence under any regime or arrangement that is materially more favorable than the corporate income tax otherwise generally imposed by such country

Notice 2009-8, Q&A-8(a).

Expansiveness of Nonqualified Entity Definition under Current Guidance

The broad language in the statute referring to corporations subject to a comprehensive income tax initially suggested to practitioners that a foreign corporation could be excluded from this definition if it was eligible for the benefits of a comprehensive income tax treaty between the foreign country and the United States. However, under the limited Section 457A guidance, the IRS narrowed the availability of this exclusion significantly. In particular, if: (1) the foreign corporation is resident in a jurisdiction that excludes nonresidence source income for purposes of calculating corporate income tax in that jurisdiction, "in whole or in part" (as further described below), and (2) in the relevant year more than 20% of the foreign corporation's gross income (determined using U.S. tax principles) is excluded because it is nonresidence source income, then the foreign corporation will **not** be treated as subject to a comprehensive foreign income tax (and thus will be subject to Section 457A). Notice 2009-8, Q&A-8(b).

For these purposes, nonresidence source income is deemed excluded by a foreign corporation's country of residence if the foreign corporation's taxable income does not include such gross income, or excludes such income by means of exemption, exclusion, or deduction (including a dividends received deduction) which results in taxation of such income at a rate less than 50% of the generally applicable rate, or by other means. Notice 2009-8, Q&A-8(c).

There are many jurisdictions in the world that exclude nonresidence source income (or tax it much more favorably than residence source income) under their domestic tax laws. Some jurisdictions may entirely exclude nonresidence source income (e.g., Singapore). Others may exclude it, subject to anti-deferral regimes (e.g., the Netherlands), while still others may exempt substantially all dividends from nonresident entities from their calculation of taxable income (e.g., Luxembourg and France). Others exclude a portion of nonresidence source income where a sufficient percentage of overall income is nonresidence source income and a sufficient percentage of expenses are paid abroad (e.g., Switzerland). As a result, it may be that few deferred compensation plans of foreign entities may be excluded from Section 457A without going through the difficult process of calculating whether the 20% threshold is exceeded each year.

Short-Term Deferrals under Section 457A

Like Section 409A, Section 457A provides an exemption for short-term deferrals. Compensation that is paid within 12 months after the end of the service recipient's taxable year in which the right to the compensation becomes vested (i.e., is no longer subject to a substantial risk of forfeiture for purposes of Section 457A) is exempt from Section 457A. For purposes of this exception, the relevant taxable year is the taxable year of the service recipient to which the services are **directly** provided at the time the right to the compensation becomes vested (i.e., the service provider is not permitted to use the taxable year of a parent or subsidiary of the entity to which the services are directly provided). Notice 2009-8, Q&A-4

Like Section 409A, Section 457A has its own definition of substantial risk of forfeiture. However, the definition is more limited under Section 457A than it is for Section 409A purposes. A substantial risk of forfeiture under Section 457A exists only if the service provider's right to the compensation is "conditioned upon the future performance of substantial services" by the service provider. Unlike under Section 409A, a substantial risk of forfeiture is not considered to exist for purposes of Section 457A merely because the right to the compensation is subject to the occurrence of a condition related to the purposes of the compensation, such as the achievement of a performance objective. Notice 2009-8, Q&A-3

For additional information on this topic, see Nonqualified Deferred Compensation Rules for Tax-Indifferent Entities (Section 457A).

Nonqualified Deferred Compensation Assessment Checklist for Expatriates and Inpatriates

In view of the numerous exceptions to Section 409A for internationally mobile employees, the steps that may be necessary to take advantage of an exception or to bring a compensation arrangement into compliance with Section 409A, as well as considerations around Section 457A, you should consider the following action items when developing expatriate and inpatriate assignments.

Expatriates:

- Take an inventory of all foreign compensation plans in which an expatriate may be eligible to participate while working outside the United States.
- Identify any broad-based retirement plans, pension plans, or other plans that may fall within an exception to Section 409A, bearing in mind any conditions that may need to be met for expatriates who are U.S. citizens or permanent residents to qualify for the exception (e.g., ineligibility for participation in a U.S. qualified plan or adherence to U.S. qualified plan limits).
- Where foreign plan exceptions are not available for a foreign nonqualified deferred compensation arrangement, assess whether it is possible, in view of assignment length and employment structure, for the expatriate to continue participating in U.S. deferred compensation and retirement plans, which should already be 409A compliant, in lieu of the foreign arrangement. This approach may require a plan amendment to allow for expatriate participation.
- If foreign plan exceptions do not apply and continued participation in one or more U.S. plans is not possible, address participation of the expatriate in foreign plans in a manner that qualifies for the short-term deferral exemption or that complies with Section 409A. This approach may require adoption of plan amendments to establish special rules for participation by U.S. taxpayers (e.g., setting forth Section 409A-compliant time and form of payment provisions).
- Review special expatriate benefits for Section 409A issues. Ensure that the expatriate agreement or other governing document is drafted to encompass Section 409A's special timing rules for payment of any tax-equalization payments, including that any equalization of additional U.S. taxes due as a result of the assignment will need to be paid within the shorter period required for tax gross-up payments. Design other expatriate benefits such as relocation payments and cost-of-living allowances to fall within the short-term deferral exemption.
- Exercise caution around allowing expatriates to participate in foreign funded deferred compensation plans, due to U.S. taxation upon vesting of amounts under such plans.
- Consider whether the Section 911 foreign earned income exclusion may help to shield any portion of the expatriate's foreign earned income from U.S. taxation, including Section 409A.
- Consider whether Section 457A needs to be reviewed, depending on whether the entity to which the expatriate will be providing services is a non-U.S. entity that may be a nonqualified entity for Section 457A purposes. If Section 457A is going to apply, the ability to participate in deferred compensation arrangements will be substantially restricted.

Inpatriates:

- Take an inventory of any foreign compensation plans in which an inpatriate is participating prior to transfer to the United States.
- Identify any broad-based retirement plans, pension plans, or other plans that may fall within an exception to Section 409A and in which the inpatriate may continue participating while working in the United States, subject to any U.S. qualified plan limits (noting that U.S. limits will not be relevant if the broad-based foreign retirement plan exclusion applies and the inpatriate is not a U.S. citizen or permanent resident).
- Identify previously vested deferred compensation that may be paid under an exception to Section 409A even after the inpatriate commences service in the United

States. Consider whether the vesting of any unvested deferred compensation should be accelerated prior to attaining U.S. residency or frozen for the duration of the inpatriate's assignment in the United States to avoid adverse consequences under Section 409A.

- Make use of Section 409A's limited grace period for new inpatriates by bringing any continuing plans into compliance with Section 409A in the first calendar year of the inpatriate's residency and assessing whether to permit inpatriates to make initial deferral elections of any unearned or unvested compensation prior to the end of such year.
- Consider whether Section 457A needs to be reviewed, depending on whether the entity to which the inpatriate will be providing services is a non-U.S. entity that may be a nonqualified entity for Section 457A purposes. If Section 457A is going to apply, the ability to participate in deferred compensation arrangements will be substantially restricted.

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