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Are You Prepared?
Uncertainty of Section 409A's Impact on Multinational Corporations Looms

The American Jobs Creation Act of 2004, which primarily was focused on corporate tax matters for multinational companies, also made far-reaching changes to the U.S. tax rules for nonqualified deferred compensation plans. These changes are contained in new section 409A of the Internal Revenue Code. Under Section 409A, deferred compensation arrangements must comply with strict standards with regard to timing of deferrals and distributions and Section 409A puts limits on the use of foreign trusts and funding triggered by the company's financial health. Failure to comply with these standards will mean current taxation of the deferred compensation with a 20% excise tax added.

It is important to note that Section 409A is applicable to worldwide income earned by U.S. citizens working abroad (i.e., expatriates) and resident aliens working inside or outside of the U.S., and U.S.-source income earned by foreign employees working temporarily in the U.S. (i.e., nonresident aliens). In addition, since Section 409A generally prohibits funding deferred compensation through a foreign trust, this prohibition will inevitably result in unintended tax consequences for expatriates and resident and nonresident aliens. As a result, it is imperative that multinational corporations understand Section 409A's impact.

On December 20, 2004, the Treasury Department and the Internal Revenue Service issued Notice 2005-1 which provided initial transitional guidance intended to assist plan sponsors in implementing the new requirements for new and existing nonqualified deferred compensation arrangements. The Notice requires plan sponsors to amend their plans in order to comply with Section 409A in form by December 31, 2005. Although a second round of guidance on the new rules is expected late this summer, this guidance is not expected to fully address Section 409A's impact on multinational corporations. Despite the lack of guidance on Section 409A, multinational corporations and foreign governments must be aware of the following:

- *Expatriates, Resident and Nonresident Aliens* – Compensation earned by an expatriate or resident alien is subject to U.S. tax laws regardless of the jurisdiction in which the compensation is earned. Therefore, the deferral of such compensation will be subject to Section 409A. In addition, U.S-source income earned by a nonresident alien (or non-U.S. source income connected with a U.S. trade or business) will be taxed under U.S. tax laws. Thus, if a nonresident alien defers such U.S.-source income, the income will be subject to Section 409A subject to any treaty override.

  In response to Section 409A, employers are trying to determine whether compensation arrangements they have with their employees (i.e., individual arrangements or group plans; written plans or unwritten arrangements; funded or unfunded arrangments) will be adversely affected. For multinational companies, this examination will be even more difficult since in many instances there will be arrangements that are trying to make whole either U.S. employees abroad or foreign employees in the U.S. from the consequences of working outside of their home country. Nevertheless, since penalties apply to participants of deferred compensation arrangements that do not comply with Section 409A, it is imperative that multinational employers scrutinize their arrangements.

- *Non-U.S. Retirement Plans* – Section 409A does not apply to retirement plans that are qualified under the requirements set forth in the Internal Revenue Code. A non-U.S. retirement plan will generally be subject to the Section 409A rules since it will not comply with U.S. tax qualification rules. As a result, Section 409A will apply to compensation deferred or benefits accrued by expatriates and aliens under such plans.

  The Treasury Department and the IRS have been asked to provide relief from the Section 409A rules for non-U.S. retirement plans that mirror tax-qualified U.S. retirement plans, such as non-U.S. retirement plans where contributions and allocations are not taxable under a treaty between the foreign country and the U.S. They have also been asked whether a retirement plan that conforms to the provisions in the U.S. Model Income Tax Treaty could be exempt from Section 409A. Some have asked for even broader relief. The Treasury Department and the IRS may be sympathetic to these treaty-based exclusions from the Section 409A rules. However, for non-U.S. retirement plans that neither have a treaty exemption nor reflect the model treaty, compliance with Section 409A will have to be considered.

- *Funding Deferred Compensation* – Under U.S. tax law, deferred compensation will not be immediately taxable if the deferred amounts are held in a trust, so long as the assets remain subject to the claims of the employer's creditors. Section 409A, however, enacted strict rules prohibiting the use of foreign trusts as a funding device for deferred compensation. The underlying intent of the rule was to address abuses derived from the use of trusts located in jurisdictions where creditors did not have effective access to the trust's assets due to local law. This prohibition sweeps in *any* foreign trust holding amounts subject to Section 409A, even those trusts located in jurisdictions with effective creditor access to trust assets.

  However, there is an exception to the prohibition on funding deferred compensation through a foreign trust if the foreign trust is located in the jurisdiction in which the deferred compensation was earned (i.e., the trust is located in the same jurisdiction the taxpayer renders services). Often, multinational corporations employ a U.S. citizen or alien in a particular foreign jurisdiction, and fund their deferred compensation plan through a trust located in another foreign jurisdiction. In this situation, Section 409A's funding prohibition would apply. Since the Treasury Department and the IRS have the authority to further exempt funded foreign trusts from the 409A rules, commentators have asked for a broader exclusion.

- *Nonresident Alien Becomes Resident Alien* – In certain instances, prior to becoming a resident alien, a foreign employee will be covered under a non-U.S. based deferred compensation plan to which the foreign employee deferred non-U.S. source income. If, upon becoming a resident alien, the foreign employee continues to defer income earned inside or outside of the U.S through the same foreign plan (and trust), it is unclear whether the application of Section 409A to the resident alien's deferred income will subject the non-U.S. source income previously deferred under the foreign plan to the Section 409A rules. We have heard that the Treasury Department and IRS are sympathetic to not subjecting previously deferred amounts to Section 409A. However, the deferrals (and earnings thereon) after becoming subject to U.S. taxation would still have to be addressed in the context of Section 409A.

- *Grandfathered Amounts* - Section 409A applies to compensation deferred on or after January 1, 2005. Consequently, certain deferred amounts which were earned and vested before January 1, 2005 will not be subject to Section 409A and can be paid out under the rules prior to the enactment of Section 409A. This "grandfather rule" applies unless a deferred compensation plan is materially modified on or after October 3, 2004.

  It may be that some of the deferred compensation arrangements maintained by a multinational corporation are protected under the "grandfather rule." However, it is important to note that there is some effort in Congress to repeal the "grandfather rule" with regard to pre-2005 earned and vested amounts which are funded by a foreign trust. This repeal of the "grandfather rule" is part of a technical corrections bill which has already been introduced in the House of Representatives. It is important to let legislators know the hardship that eliminating the "grandfather rule" would cause to multinational companies.

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The new rules for deferred compensation under Section 409A contain compliance challenges for all employers and particular challenges to multinational employers. Being cognizant of these new rules will keep you from providing benefits which could provide tax problems to your employees.

The Groom Law Group would be pleased to provide further information regarding Section 409A and its impact on multinational corporations. Please contact Bill Sweetnam (202-861-5427), Brigen Winters (202-861-6618), Lou Mazawey (202-861-6608) or John McGuiness (202-861-6637) for any information or assistance that you may need.