

Section 409A

Introduction

Let's take an instance of a foreign multinational who sends its senior executive to the United States to become president of its U.S. subsidiary. The executive goes on the payroll of the U.S. company and becomes a U.S. tax resident. He also continues to be the beneficiary through the parent company of various stock options and other nonqualified deferred compensation (NQDC) plans. The foreign parent's executive compensation plans do not conform to the Sec. 409A rules. Can Sec. 409A tax and penalize employees if an employer does not itself have a U.S. taxable presence?

The short and clear answer is yes. While the regulations under Sec. 409A do provide helpful exceptions to this result, it is clear that U.S. citizens or tax residents and their non-U.S. employers are required to comply with Sec. 409A or be subject to its consequences since the rules apply based upon the U.S. tax status of the employee.

Applicability of Section 409A

The greatest exposure would appear to be with inbound employees who are participants in a foreign plan that does not meet any of the exceptions and who are not fully vested in their plan benefits at the time of becoming a U.S. tax resident. These would run the risk of being taxed under Sec. 409A on accumulations while a nonresident in addition to accumulations post-residency if they become vested while a U.S. tax resident. The best tax planning opportunity in this case would appear to be to ensure that such employees are fully vested before becoming U.S. tax residents and that further vesting is frozen while the employees are U.S. tax residents.

Application of Sec. 409A is not limited to plans maintained in the United States, nor is it necessarily limited to deferred compensation earned for service performed in the United States. Therefore, Sec. 409A can come into play in the case of deferred compensation agreements for either inbound or outbound employees as long as the employee is a U.S. tax resident or a citizen.

Consequences

The consequences of failure to comply with Sec. 409A rules can be significant. Sec. 409A, in summary, governs tax results of NQDC plans. It covers the manner and circumstances under which elections or agreements to defer compensation can be made and the timing and circumstances under which distributions can be made. Furthermore, the rules provide that an employee participant in any NQDC plan that does not comply with Sec. 409A will be taxed currently upon the deferred income amount when the amount is vested and no longer subject to a substantial risk of forfeiture. In addition to the tax, the employee will owe interest and a 20% additional tax.

The Sec. 409A regulations do provide relief in a number of instances. Regs. Sec. 1.409A-3(h) provides that an NQDC plan will be deemed to meet the requirements of Sec. 409A for the first year that the employee or service provider is considered to be a U.S. tax resident as long as, by the end of the first year that the employee is a U.S. tax resident, the plan is amended to meet the Sec. 409A requirements.

Source: Tax Adviser Nov 2008.

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