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Foreign Executives Moving To The United States To Work: What To Know About Your Company's Nonqualified Deferred Compensation Plan

by Michael Melbinger

If you become a taxpayer in the United States and participate in a nonqualified deferred compensation (NQDC) plan, you need to be concerned about both Section 409A and Section 457A of the US Internal Revenue Code. If your employer's NQDC plan located outside the US does not satisfy the requirements of Section 409A, all compensation deferred may be immediately subject to income tax and an additional 20% excise tax, even if that compensation was earned and deferred before you moved to the US. By contrast, Section 457A will apply only if you continue to defer compensation paid by an employer located in a tax haven outside the US.

IRC Section 457A

Section 457A simply prohibits deferrals by US taxpayers employed by tax-indifferent entities (such as certain foreign corporations in "tax haven" jurisdictions). Under Section 457A, "deferred amounts" under the plan of "a nonqualified entity" are includible in your gross income as soon as there is no substantial risk of forfeiture. Section 457A originally targeted compensation in offshore hedge funds. However, it was poorly drafted and applies to all deferred compensation attributable to services performed in a tax-indifferent jurisdiction after December 31, 2008. Section 457A provides no grandfathering provisions for pre-2009 deferrals.

> **Alert:** Section 457A does not change the taxation of stock options and stock-settled stock appreciation rights as long as the awards are settled in stock and are designed to satisfy Section 409A's "stock right" exemption, as the IRS clarified in Revenue Ruling 2014-18.

409A Exemptions For Nonresident Aliens

Section 409A imposes numerous rules on nonqualified retirement plans and deferred compensation plans maintained either within or outside the US. When a nonresident alien earns deferred compensation for work outside the US and then becomes a US resident ("imported deferred compensation") after the compensation is vested, but while it is still deferred, an exemption from Section 409A is available. To qualify for this exemption, the compensation must not have been includible in your gross income for US tax purposes when you received the right to the compensation, whether you received that right immediately or only after it was no longer subject to a substantial risk of forfeiture (i.e. when it vested).

> **Alert:** This exemption does not apply to any additional increments of deferred compensation you may accrue after you become a US tax resident.

However, if you earn deferred compensation for work outside the United States and then become a US tax resident *before the compensation has vested*, but while it is still deferred, the imported deferred compensation generally will be subject to Section 409A, though a grace period is available in limited circumstances. The grace period for this unvested, imported type of deferred compensation applies only if the employer/plan sponsor modifies the plan or arrangement under which you previously deferred compensation so that it complies with Section 409A or satisfies an exception to 409A. The employer/plan sponsor must amend the plan or arrangement during the calendar year in which you become a US tax resident (the "grace period"). Ideally, your company will be aware of this trap before it transfers you to the US so that it can amend the deferred compensation plan or agreement to comply with Section 409A or cause it to vest before your transfer.

The 409A regulations also contain an exception for imported deferred compensation, vested or not, under a "broad-based plan" (typically a foreign employer's pension or retirement plan). This exception is available to you for any tax year in which you remain a nonresident alien, become a resident alien under the physical-presence test (and are not a greencard-holder), or are an alien who is a *bona fide* resident of certain US possessions. To qualify as broad-based, the plan must be: (1) written, (2) nondiscriminatory, and (3) restricted to use for retirement or subject to tax that discourages use other than for retirement or for periods after separation from service; and (4) substantially all of the active participants in the plan must be nonresident aliens or resident aliens.

Finally, 409A provides a *de minimis* exception for situations in which you perform some services in the US that relate to a foreign deferred compensation plan but are not physically present in the US for long enough to create US resident status. To qualify for this exemption, you must be a nonresident for the year of the compensation deferral, and the amount of deferral must not exceed the limit under IRC Section 402(g)(1)(B), i.e. $18,000 for 2015, with no increase or catchup for those aged 50 and older.

Distributions

If you receive distributions under a deferred compensation plan maintained outside the US while you are living in the US, the tax treatment of that distribution will be governed by the tax treaty between the US and your country of origin or the country from which the distribution is made. If there is no tax treaty, or if it is silent on deferred compensation distributions, the distribution will be subject to US income tax.

FATCA Reporting

The Foreign Account Tax Compliance Act (FATCA) requires individuals who become US taxpayers to file Form 8938 with the IRS reporting "foreign financial assets" with an aggregate value exceeding $50,000. (A more publicized provision of FATCA requires foreign financial institutions to disclose any funds they hold on behalf of US taxpayers (FBAR).) FATCA imposes substantial penalties on individual US taxpayers who fail to file. The penalty for a failure to file Form 8938 could be up to $10,000, with a maximum penalty of up to $50,000 for a continuing failure to file.

“Foreign financial assets” include:

- foreign equity awards, and/or
- an interest under a foreign pension or deferred compensation plan, even if the individual is no longer actively accruing benefits under the plan.

FATCA imposes the responsibility to make the required filing on the employee, not the employer. However, many companies with inpatriate or multinational employees will at least consider alerting their employees to the filing obligation, and some provide assistance with the filing.

FATCA provides limited exemptions from the reporting requirement for (1) interests in foreign governmental retirement schemes, such as social insurance, (2) accounts reported on Form 8891 (*US Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans*), and (3) certain financial accounts that are maintained by a US taxpayer at a US branch of a foreign financial institution or a foreign branch of a US financial institution.

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