



# New US Tax Laws May Impact Deferred Compensation Arrangements

**Chris M. Kang, September 2009**

Multinational companies with service providers (i.e., employees or independent contractors) who are US citizens or residents (working in the US or abroad) should be aware of new US tax laws that may have a significant impact on their deferred compensation arrangements. Under new Section 457A of the US Internal Revenue Code, compensation for services performed after 31 December 2008 which is deferred under a nonqualified deferred compensation arrangement of a 'nonqualified entity' is taxable to the service provider in the year it vests, whether or not received. If the deferred compensation is not included in income and taxed when vested, the service provider is subject to excise taxes and interest penalties.

Section 457A applies if: (i) the company is a 'nonqualified entity'; (ii) the company is the 'sponsor' of a deferred compensation arrangement; and (iii) a US taxpayer participates in the deferred compensation arrangement.

A foreign corporation is a 'nonqualified entity' unless substantially all of its income is subject to US income tax or subject to a 'comprehensive' foreign income tax. As a general matter, a corporation formed in a 'tax haven' jurisdiction, such as the Netherlands Antilles, Bermuda or the Cayman Islands, will be a nonqualified entity. However, even a corporation located in a non-tax haven jurisdiction may be a nonqualified entity. For example, the corporation may be a nonqualified entity if it is resident in a country that provides an exemption or reduced tax rate for nonresident source income or if it is otherwise subject to more favourable tax rates. A partnership (foreign or domestic) is a nonqualified entity unless substantially all of its income is allocated to persons other than (i) foreign persons who are not subject to a comprehensive income tax, and (ii) US tax-exempt entities. In any case, determining whether a company is a 'nonqualified entity' will likely require a complex and in-depth analysis.

If a company is a 'nonqualified entity', it should determine whether it is the 'sponsor' of a deferred compensation arrangement. The 'sponsor' is the entity that would be entitled to a deduction for the deferred compensation (if paid immediately) under US federal income tax principles. For instance, suppose a parent foreign corporation has a deferred compensation arrangement in which a US taxpayer participates, but the compensation expense for that US taxpayer is charged back to, and is deductible by, the foreign parent's US subsidiary that employs that US taxpayer. In that case, the US subsidiary is considered the 'sponsor' of the arrangement, and the arrangement is not subject to Section 457A, even if the foreign parent is resident in a jurisdiction where corporations are considered nonqualified entities. On the other hand, if the US taxpayer works for the parent or a foreign subsidiary or affiliate and the compensation expense is deductible by the foreign entity (and therefore not charged back to a US subsidiary), then the arrangement may be subject to Section 457A, provided the foreign entity is a 'nonqualified entity'.

Section 457A generally applies to deferred amounts attributable to services performed after 31 December 2008. For amounts attributable to services performed before 1 January 2009, companies have until 31 December 2011 to modify the arrangement and comply with Section 457A without violating Section 409A. While the IRS provided transition relief to amend arrangements that are subject to Section 457A, the relief was limited in scope and not useful to employers who did not wish to accelerate the vesting of their compensation arrangements or accelerate the vesting for all service providers. As a result, multinational companies should still examine the applicability of Section 457A to their compensation arrangements.

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