

## Client Alert

# Treasury and IRS Exempt Many Foreign Plans and Arrangements Under Proposed 409A Regulations

As we noted in our recent client alerts, the Treasury Department and Internal Revenue Service have issued the long-awaited “second round” of guidance under Internal Revenue Code Section 409A (“409A”). This client alert discusses how the new guidance, issued in the form of proposed regulations, impacts foreign plans and employees.<sup>1</sup>

### Links to 409A Guidance

For a more general summary of the proposed regulations, see our client alert entitled “Treasury and IRS Issue ‘Second Round’ of 409A Guidance: What You Need to Know and Do Before Year End.” For a link to that and other client alerts on 409A, and to the proposed regulations, Notice 2005-1, and 409A, click [here](#) or go to <http://www.chadbourne.com/409A>.

### Foreign Arrangements That Are Exempt From 409A

The new guidance exempts certain foreign arrangements from 409A. In some cases, the exemptions are without limit. In other cases, the exemptions are limited to a certain dollar amount or to certain individuals. These exemptions are as follows:

**Exemptions for Broad-Based Foreign Retirement Plans.** There are two different exemptions for foreign broad-based retirement plans:

- The first exemption applies to nonresident aliens<sup>2</sup> and resident aliens (as defined under Code Section 7701(b)(1)(A)(ii)) (generally, individuals who reside in the U.S. and who have met the “substantial presence” test). This exemption applies to broad-based foreign retirement plans in which such individuals participate that are maintained by non-U.S. persons, without regard to the additional requirements imposed upon U.S. citizens and other resident aliens (see next exemption).
- The second exemption applies to U.S. citizens and resident aliens (as defined under Code Section 7701(b)(1)(A)(i)) (generally, individuals who have lawfully been admitted into the U.S. for permanent residence). This exemption applies to broad-based foreign retirement

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<sup>1</sup> Because the regulations are only “proposed” at this stage, they do not have the force of law. However, the IRS has provided that reliance on the proposed regulations will be evidence of an employer’s good faith attempt to comply with 409A. A public hearing on the proposed regulations is scheduled to be held in January 2006, and the regulations are expected to be finalized later in 2006.

<sup>2</sup> The term “nonresident alien” is defined in the new guidance by cross-referencing other Code Sections. Generally, a “nonresident alien” is an individual who is not a U.S. citizen and who does not qualify as a resident of the U.S. (for example, because he or she is not living in the U.S. or is living in the U.S. on a temporary basis).

plans in which such individuals participate and that are maintained by non-U.S. persons and meet the following requirements:

- the exemption only applies to non-elective deferrals (*i.e.*, deferrals that the individual is required to make) of foreign earned income (as defined under Code Section 911(b)(1));
- the exemption only applies to the extent that the non-elective deferrals during the tax year in question do not exceed the applicable limits under Code Sections 415(b) and 415(c)<sup>3</sup> that would apply if the arrangement were subject to Code Section 415 and the foreign earned income of the individual was treated as “compensation” for purposes of Code Sections 415(b) and 415(c); and
- the exemption does not apply if the individual is eligible to participate in certain U.S. tax-qualified retirement arrangements.

For purposes of these exemptions, a broad-based retirement plan is a written plan or arrangement that:

- for an employer-maintained plan, covers a wide range of employees, substantially all of whom are nonresident aliens or resident aliens, including rank and file employees, and which actually provides significant benefits to the employees covered;
- for an employer-maintained plan, limits employees’ ability to use benefits other than for retirement or restricts access to benefits before separation from service, and that is subject to a scheme (whether statutory, contractual, or otherwise) that discourages use of benefits prior to retirement; and
- provides for a reasonable level of benefits upon death, a stated age, or an event related to work status, and requires minimum distributions designed to ensure that any death benefit is simply incidental to the retirement benefits.

***Exemption for Transfers Under Code Section 402(b).*** The new guidance exempts from 409A transfers that are taxable under Code Section 402(b). Such transfers may include contributions to an employees’ trust that does not qualify under Code Section 501(a).

***Exemptions for Certain Compensation That Is Excluded from Income.*** These exemptions apply to arrangements under which compensation would not have been includible by an individual in gross income for U.S. federal income tax purposes had such compensation been paid to the individual at the time the legally binding right to the compensation first arose (or, if later, the time at which the compensation is first no longer subject to a substantial risk of forfeiture) because:

- the individual was a nonresident alien and the compensation would not have been included in gross income under Code Section 872 (certain compensation earned by nonresident aliens);

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<sup>3</sup> The Code Section 415(b) limit is the maximum annual benefit payable to a person under a defined benefit plan. The limit is \$170,000 for 2005 and \$175,000 for 2006. The Code Section 415(c) limit is the maximum annual contribution per person under a defined contribution plan. The limit is \$42,000 for 2005 and \$44,000 for 2006.

- the individual was a “qualified individual” (as defined under Code Section 911(d)(6)) and the compensation would have been foreign earned income (within the meaning of Code Section 911(b)(1)) if paid at that time;<sup>4</sup> or
- the compensation would have been excludible from gross income under Code Section 893 (compensation paid to foreign workers of a foreign government or international organization working in the U.S.), 931 (compensation earned by residents of Guam, American Samoa, or the Northern Mariana Islands), or 933 (compensation earned by residents of Puerto Rico).

As an example of the application of one of these exemptions, the preamble to the new guidance provides that, in the case of a foreign citizen who works outside the U.S. but then retires to the U.S., his or her compensation that is deferred and vested while he or she is working outside the U.S. will generally not be subject to 409A.

***Exemptions for Arrangements Covered By International Tax Treaties and Agreements.*** One exemption applies to an arrangement under which contributions made by or on behalf of an individual are excludible by that individual for U.S. federal income tax purposes due to a tax treaty to which the U.S. is a party.

A second exemption applies to an arrangement under which compensation would have been excluded from gross income for U.S. federal income tax purposes due to a tax treaty or other international agreement to which the U.S. is a party had such compensation been paid to the individual at the time the legally binding right to the compensation first arose (or, if later, the time at which the compensation is first no longer subject to a substantial risk of forfeiture).

***Exemption for Tax Equalization Arrangements.*** An arrangement that provides for “tax equalization” payments is exempt from 409A, as long as the payments are made no later than the end of the second calendar year beginning after the calendar year in which the individual’s U.S. federal income tax return is required to be filed for the year to which the tax equalization payment relates.<sup>5</sup> A payment is not exempt from 409A merely because it is categorized as a tax equalization payment or expatriate allowance by the contracting parties. While the Treasury and IRS believe that sufficient relief from 409A has been provided for expatriate allowances, they have also requested comments on this issue.

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<sup>4</sup> This exemption only applies to the extent that the compensation is less than the difference between the maximum exclusion under Code Section 911(b)(2)(D) for the tax year in question and the amount of foreign earned income that is actually excludible from gross income under Code Section 911(a)(1) by the individual for the tax year in question. Generally, U.S. citizens and resident aliens who work in a foreign country may exclude up to \$80,000 of foreign earned income from their gross income.

<sup>5</sup> A “tax equalization arrangement” is defined as an arrangement that provides an individual with a payment to compensate him or her for the taxes that are imposed on his or her compensation (but not on the tax equalization payment) by a foreign jurisdiction that are in excess of the taxes that would have been imposed on the individual had his or her compensation just been subject to U.S. federal income taxes. Payments under a tax equalization arrangement may not exceed such excess amount plus the amount of any additional taxes imposed on the tax equalization payment.

**Exemption for Foreign Social Security Arrangements.** Compensation received under any foreign social security system (1) to the extent that benefits are provided under or contributions made to a government-mandated plan, or (2) that is subject to an agreement entered into with a foreign jurisdiction under Section 233 of the Social Security Act, is exempt from 409A.

**De Minimis Exemption for Nonresident Aliens.** This exemption covers nonresident aliens and applies to an arrangement maintained by a non-U.S. person to the extent that amounts deferred under the arrangement based upon the individual's services performed in the U.S. do not exceed \$10,000 for the tax year in question.

**Exemption for Earnings.** Earnings on any of the above-exempted compensation arrangements are also excluded from 409A.

### **Grace Periods for Individuals Upon First Becoming Resident Aliens**

The proposed regulations provide a grace period for any person who becomes a resident alien during a calendar year. During the grace period, the arrangement can be amended to comply with, or be excluded from, 409A. The grace period applies to both initial deferral elections by, and payments made to, the individual during that first calendar year in which he or she becomes a resident alien.

- **Initial Deferral Elections.** The grace period allows the individual to make his or her initial deferral election to defer amounts subject to 409A during the first calendar year in which the individual becomes a resident alien, provided that the deferral election only applies to amounts paid or first payable after the date of the deferral election.
- **Payment of Amounts.** Any amount payable under a nonqualified deferred compensation arrangement to an individual during the first calendar year in which he or she becomes a resident alien is automatically treated as complying with 409A's time and form of payment rules. Also, amounts payable in subsequent calendar years will be treated as complying with 409A's time and form of payment rules if the arrangement is amended to comply with those rules by December 31st of the calendar year in which the individual becomes a resident alien.

In both cases, this grace period is only available to the extent that the individual was not a resident alien for any of the five calendar years immediately preceding the year in which the individual becomes a resident alien. As a result, individuals who were once resident aliens but have not been since for at least five consecutive calendar years may (again) take advantage of this grace period during the first year in which they again become resident aliens.

### **So, What is Not Exempt?**

Income received by U.S. citizens working abroad and resident aliens working in the U.S., absent an applicable treaty provision, generally will be subject to U.S. federal income tax, including Code 409A.

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If you would like to discuss the application of 409A to your foreign plans or compensation arrangements, or if you have any questions, please feel free to contact us.

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### **For Additional Information**

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