Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 30: The Impact of 457A on Deferred Compensation from non-US Entities

By Darren Goodman, Megan Monson, Sophia Mokotoff, Taryn Cannataro

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Taryn Cannataro: Welcome to the latest episode of Just Compensation. I'm Taryn Cannataro, a council in the Executive Compensation and Employee Benefits Group, and I'll turn it over to my colleagues to introduce themselves.

Darren Goodman: I'm Darren Goodman, the vice chair of the Employee Benefits and Executive Compensation Group.

Megan Monson: And I'm Megan Monson, a partner in the same practice group as Darren and Taryn.

Sophia Mokotoff: And I'm Sophia Mokotoff, partner in the Tax Group.

Taryn Cannataro: Today's discussion we'll focus on the Internal Revenue Code Section 457(a), which is a complex area of the tax code and should be considered if a US person may receive deferred compensation from an overseas entity. Section 457(a) was enacted to target deferral of fees of certain offshore hedge funds. However, the rules are broader and could impact any non-US entity. Today we'll talk about when 457 applies, to whom it applies and some key similarities and differences between sections 457(a) and 409(a), which is the code provision that people normally consider in connection with deferred compensation.

As always, this is not intended to be an exhaustive discussion. We encourage you to consult with legal counsel to discuss how 457(a) may apply to your particular situation.

Let's start from the beginning. What is section 457(a) and when does it apply?

Darren Goodman: 457(a) is a provision of the tax code that, as you said, governs non-qualified deferred compensation. It applies what is called a non-qualified entity. We'll talk about that more later. But just to set the stage 457(a) and 409(a) both regulate deferred compensation, and the rules are similar in some ways, but there are also some notable differences. For example, 457(a) applies to both cash and accrual method service providers, whereas 409(a) only applies to cash method service providers. 457(a) includes stock appreciation rights that are settled in cash, whereas 409(a) has exemptions for those as long as certain requirements are met, and these aren't

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mutually exclusive either. You could end up in a situation where you need to consider compliance with both 409(a) and 457(a).

Megan Monson: So in general, certain items are not considered non-qualified deferred compensation under either 409(a) or 457(a). So a couple of key examples are equity interests in a partnership, stock options granted at fair market value and payments made within the short-term deferral period. For 457(a) amounts are considered to be exempt from being considered deferred compensation if the amounts are paid no later than 12 months after the end of the taxable year, during which the right to receive the amount is no longer subject to a substantial risk of forfeiture. The rule is based on when the deferred amount is actually paid.

And so the 457(a) short-term deferral definition differs from the 409(a) definition in a few key ways. First being the period for 457(a) purposes is 12 months instead of two and a half months after the end of the calendar year. The definition of substantial risk of forfeiture is narrower and it also applies based on whether the payments are actually made, not on whether they must be made within the applicable timeframe. So as kind of Darren mentioned, there are some similarities but some key differences to be aware of.

In addition, there's also an exemption from 457(a) for payments made to independent contractors. The same definition is used under 457(a) to meet this exemption as is used under 409(a). It's not enough that a person is simply an independent contractor, but they must meet the specific test which relates to the duties that they're performing and the amount of compensation they're receiving.

Taryn Cannataro: Darren, Sophia, when should we be thinking of 457(a)?

Darren Goodman: You should think about 457(a) whenever there's an arrangement with a non-US entity. 457(a) can be relevant for people in the US that enter into arrangements with non-US entities. For example, someone in the US who's being hired by a company overseas that doesn't have a US subsidiary. So the contract is directly between a company outside the US and someone in the US.

Another situation where it could apply is someone who is outside the US and entering into an agreement directly with a non-US entity, and Sophia can give some more color on that.

Sophia Mokotoff: So as Darren mentioned, section 457(a) can be relevant to service providers both in the US and outside the US. Overall, the rule is it can apply to individuals who are subject to US income tax, so individuals who are US citizens or US tax residents might be relevant regardless of where they perform services. For non-residents and non-US citizens, it only applies to the extent that non-qualified deferred compensation was earned through services actually performed in the United States.

Darren Goodman: And I just want to add that this can be a real trap because companies outside the US often do not have US tax expertise, they might not be thinking about US tax law at all. So this is something that could easily slip through 457(a) 409(a)or other US tax principles. It's always important to be extra careful from a tax perspective if you are overseas.

Taryn Cannataro: Can you provide us with a high-level overview of when a plan is sponsored by a non-qualified entity?

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Megan Monson: So whether an entity is a non-qualified entity is determined on an annual basis and can change from year to year. Sophia will go into a little bit more detail about specifically what type of entities are considered non-qualified entities.

Sophia Mokotoff: These rules about defining what is a non-qualified entity can get really complex. We're going to go through sort of a high-level overview of those rules to give you a few examples. So, the analysis under all of these rules really focuses on whether substantially all of the entity's income falls within specific categories. For this purpose, substantially all is defined as at least 80%.

The first category we're going to talk about are foreign corporations. For purposes of this rule, a corporation is foreign if it's formed under the laws of a non-US jurisdiction. A foreign corporation defaults to a non-qualified entity unless an exception applies. One of these exceptions is substantially all of the income of the foreign corporation is effectively connected with the conduct of a US trader business. And so this is a pretty specific term for US tax purposes. But generally, this means that 80% or more of its gross income is connected with a trader business conducted in the US and is actually taxable by the United States.

These rules can be pretty complex and subjective in terms of whether a foreign incorporation is treated as engaged in a US trader business. The analysis really focuses on the type and amount of activities being conducted by a corporation in the US to generate income. So the more a corporation is in the US, the more likely it will be found to be engaged in a US trader business that generates CCI.

Another exception is where substantially all of the income of the foreign corporation is subject to a comprehensive foreign income tax. Generally, this means that the foreign corp is eligible for the benefits under a comprehensive income tax treaty between its country of residence and the US. The foreign corp is not taxed under any regime or arrangement that's materially more favorable than the corporate income tax generally imposed by that non-US jurisdiction, and the corporation's country of residence actually taxes non-resident source income. This gets into a lot of technical rules and considerations.

Another category of potentially non-qualified entities are partnerships. And here we're not just looking at foreign partnerships, partnerships formed under the laws of the US can also be non-qualified entities. Generally speaking, if more than 20% of the partnership's gross income for a tax year is allocated to what are known as ineligible persons or entities, then the partnership is a non-qualified entity for that year. Ineligible persons or entities include non-US persons who are not subject to comprehensive foreign income tax in organizations that are tax-exempt under US rules including US public charities for example. As you can see, these rules get really complicated because the focus is really on the taxation of the partners of the partnership.

Taryn Cannataro: Megan, when is non-qualified entity status determined?

Megan Monson: So it's determined for the taxable year of the foreign corporation in progress for the last day of each of the service providers tax years in which compensation has been vested but remains deferred. So I'll just say all of these questions and about what is considered a non-qualified entity and how is assessed to determine this is a very complex analysis and determination and so it goes back to Darren's point of making sure that you one, understand that this does impact entities outside of the US. And two, the importance of engaging with your tax or legal advisors to understand if you are going to be swept up under these rules. If you're entering into any arrangement providing for deferred compensation

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Taryn Cannataro: And when is compensation that is subject to 457(a) includable in income?

Darren Goodman: So in plain English - under 457(a), you can be taxed as soon as amounts are vested even if they haven't been paid out. For 457(a) purposes amounts are only not vested if there's a continued employment requirement, you have to stay employed through a particular date in order to get paid. If you have an arrangement where you do not have a continuing employment requirement, but you have another performance-based vesting element, such as company revenue or EBITDA targets, it might not be vested for all practical purposes, but you could be vested for 457(a) purposes and that's a big difference from the 409(a) rules. If you cannot determine the amount of the compensation at the time it becomes vested, then tax is delayed until the amount actually becomes determinable. But at that time there's a 20% penalty tax as well as interest charges. So long story short, you could be in the situation either where you're taxed on something you haven't been paid or you're not taxed until you're paid, but you're hit with a 20% penalty plus interest. So both are bad outcomes tax wise.

Taryn Cannataro: Is there anything else that we should be aware of with respect to 457(a)?

Megan Monson: So as we mentioned, 457(a) and whether or not it applies is a really complicated area of the law and since many non-US companies are often not aware of it, the key takeaway is if a non-US company is hiring a US person to consider, one, does 457(a) apply to any of the arrangement and to bring in local counsel to help advise on it. As a related point, it can also be relevant to somebody in the US if you're being hired by an overseas company. And so again, it really just strikes the importance of having US council evaluate any sort of compensation arrangements to determine whether 457(a) is something that needs to be complied with in addition to other US law.

Taryn Cannataro: As you've heard today, it's important to keep 457(a) in mind when dealing with non-qualified deferred compensation arrangements from non-US entities. As you can see, the rules of 457(a) just like 409(a) can be very tricky and technical. While the rules of 457(a) and 409(a) are similar, there are also key differences to be mindful of, especially if there's an arrangement that could be subject to both. US legal counsel should be considered if you're looking to put in place any arrangement that could be subject to 457(a) or 409(a) in order to avoid adverse tax consequences.

This episode is intended to be a high-level overview but is by no means an exhaustive discussion. Thank you for joining today. We look forward to having you back for our next episode of Just Compensation.

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