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to: Division Counsel/Associate Chief Counsel
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subject: Application of Section 409A to Back-to-Back Arrangement

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Foreign Corporation =

USR Plan =

ISR Plan =

Employee A =

ISSUE 1

The USR Plan is a back-to-back arrangement sponsored by the ultimate service recipient, Foreign Corporation, providing for payments to be made to Taxpayer, the intermediate service recipient, in excess of the payments to be made to the Participants under the ISR Plan. Does the USR Plan meet the requirements that apply to back-to-back arrangements under Treas. Reg. §1.409A-3(i)(6)?

CONCLUSION

No. Treas. Reg. §1.409A-3(i)(6) provides that the amount of the payment under the ultimate service recipient plan may not exceed the amount of the payment under the intermediate service recipient plan. Therefore, the USR Plan fails to meet the requirements of section 409A because the USR Plan provision providing for a payment to Taxpayer in the event of a Participant's separation from service before vesting is an impermissible payment event.

FACTS

Taxpayer is a United States taxpayer that manages many investment funds, both overseas and in the United States, including Foreign Corporation. Foreign Corporation pays Taxpayer management and performance fees for investment advisory services, and Taxpayer in turn employs individual investment professionals who receive salaries and bonuses for management and investment advisory services performed.

Foreign Corporation and Taxpayer were parties to a deferred compensation arrangement ("USR Plan") under which Taxpayer deferred some of its management fees and/or performance fees. Taxpayer in turn sponsored a deferred compensation arrangement ("ISR Plan") for individual investment professionals ("Participants") working for Taxpayer. The USR Plan and the ISR Plan were intended to be "back-to-back" arrangements. Thus, under the USR Plan and the ISR Plan, Taxpayer's deferral elections were coordinated with the Participant's deferral elections, and the payment events triggering payments from Foreign Corporation to Taxpayer under the USR Plan were coordinated with the payment events triggering payments to the Participants under the ISR Plan. Thus, for example if a Participant was entitled to a payment of deferred compensation upon separation from service under the ISR Plan, then Taxpayer was likewise entitled to a payment in the same amount under the USR Plan.

The USR Plan provided that a payment of deferred compensation was to be made to Taxpayer when an amount was forfeited by a Participant.

Section of the USR Plan states:

Thus, under the terms of the USR Plan between Taxpayer and Foreign Corporation, an amount was to be paid to Taxpayer even though the amount was forfeited by a Participant (and thus not paid to the Participant) because the Participant separated from service before the vesting date. During and , three Participants forfeited unvested amounts (approximately \$ million) upon their separations from service.

LAW AND ANALYSIS

Section 409A(a)(1)(A) provides that if certain requirements related to the timing of elections, distributions, and funding are not met at any time during a taxable year, amounts deferred under a nonqualified deferred compensation plan for that year and all previous taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Amounts includible in income under section 409A are also subject to two additional taxes under section 409A(a)(1)(B). Section 409A(a)(1)(B)(i)(II) provides that if compensation is required to be included in income under section 409A(a)(1)(A)(i) for a taxable year, the income tax imposed is increased by an amount equal to 20 percent of the compensation that is required to be included in income. Section 409A(a)(1)(B)(i)(I) provides that if compensation is required to be included in income under section 409A(a)(1)(A)(i) for a taxable year, the income tax imposed is increased by an amount equal to the amount of interest determined under section 409A(a)(1)(B)(ii).

Section 409A(a)(2) provides that compensation deferred under a plan may not be distributed earlier than death, disability, separation from service, or a fixed date set forth in the plan, or another date to the extent provided by the Secretary. Treas. Reg. §1.409A-3(a) provides that a plan must provide that an amount of deferred compensation may be paid only upon the occurrence of the following events:

- (1) the service provider's separation from service;

- (2) the service provider becoming disabled;
- (3) the service provider's death;
- (4) a time or fixed schedule set forth in the plan;
- (5) a change in ownership or control of a corporation;
- (6) the occurrence of an unforeseeable emergency.

Thus, in general, a payment to a service provider cannot be triggered by the separation from service of another service provider. For example, in the case of an investment fund, the payment to an investment manager cannot be triggered by the separation from service of an individual investment professional.

However, the regulations provide an exception for a back-to-back arrangement that meets the requirements of Treas. Reg. §1.409A-3(i)(6).

Treas. Reg. §1.409A-3(i)(6) provides:

This paragraph (i)(6) applies where a service provider is providing services to a service recipient (the intermediate service recipient), who in turn is providing services to another service recipient (the ultimate service recipient), the services provided by the service provider to the intermediate service recipient are closely related to the services provided by the intermediate service recipient to the ultimate service recipient, there is a nonqualified deferred compensation plan providing for payments by the ultimate service recipient to the intermediate service recipient (the ultimate service recipient plan), there is a nonqualified deferred compensation plan or other agreement, method, program, or other arrangement providing for payments of compensation by the intermediate service recipient to the service provider (the intermediate service recipient plan), and the intermediate service recipient plan provides for a payment upon the occurrence of an event described in paragraph (a)(1), (2), (3), (5), or (6) of this section. In such a case, notwithstanding the generally applicable limits on payments in paragraph (a) of this section, the ultimate service recipient plan may provide for a payment to the intermediate service recipient upon the occurrence of a payment event under the intermediate service recipient plan described in paragraph (a)(1), (2), (3), (5), or (6) of this section if the time and form of payment is defined as the same time and form of payment provided under the intermediate service recipient plan, the amount of the payment under the ultimate service recipient plan does not exceed the amount of the payment under the intermediate service recipient plan, and the ultimate service recipient plan and the intermediate service recipient plan otherwise satisfy the requirements of section 409A (regardless of whether such plan is subject to section 409A)."

As described above, the USR Plan provides that unvested amounts forfeited by Participants are nevertheless to be paid to Taxpayer. Thus, under the terms of the USR Plan, an amount paid to Taxpayer upon the separation from service of a Participant could be in excess of the amount paid to the Participant. Therefore, the requirements under Treas. Reg. §1.409A-3(i)(6) are not met because the amount of the payment under the ultimate service recipient plan may exceed the amount of the payment under the intermediate service recipient plan. See underlined language above. Consequently, the requirements for the exception for back-to-back arrangements are not met, and thus the USR Plan includes a payment provision that fails to meet the

requirements of Treas. Reg. § 1.409A-3(a). The payment event under the USR Plan providing for payment of an unvested amount upon separation from service of a Participant is not a permissible payment event under Treas. Reg. § 1.409A-3(a). Therefore, the USR Plan failed to meet the requirements of section 409A.

Section 409A(a)(1)(A)(i) provides that if at any time during a taxable year a nonqualified deferred compensation plan (I) fails to meet the requirements of paragraphs (2), (3), and (4) of section 409A(a), or (II) is not operated in accordance with such requirements, all compensation deferred under the plan for the taxable year and all preceding taxable years shall be includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Therefore, all vested amounts deferred under the USR Plan for the first open year that have not been previously included in income are includable in gross income under section 409A(a)(1)(A) and are subject to the additional taxes under section 409A(a)(1)(B). For taxable years after the earliest open year, the Taxpayer must include under section 409A(a)(1)(A) the vested amount deferred under the USR Plan, less amounts included for previous taxable years.

ISSUE 2

Taxpayer elected to be paid deferred compensation on certain dates and in certain amounts over several tax years. In some tax years, the payments actually made were less than the amounts called for under the USR Plan and in other tax years the payments actually made were more than the amounts called for under the USR Plan. Section 409A(a)(2)(A) and the regulations thereunder require that a payment be made at the time and in the amount specified in the plan. Did the USR Plan fail to meet the requirement of section 409A(a)(1)(A) that a plan be operated in accordance with the requirements of section 409A(a)?

CONCLUSION

Yes. The Taxpayer failed to meet the requirements of section 409A(a)(A) because the USR Plan was not operated in accordance with the requirements of section 409A(a)(2)(A) and the regulations thereunder because payments made under the USR Plan were not made at the time and in the amount specified in the plan.

FACTS

On _____, Taxpayer made “special deferral elections (deferral elections)” to defer all fees earned prior to _____ for services provided to Foreign Corporation except as follows:

Percentage of Total Deferred Fees
to be distributed

Distribution Dates

On _____, Taxpayer elected to re-defer the _____ % of fees that were scheduled to be distributed on _____. The re-deferral states _____ % of the deferred amounts credited to Taxpayer's accounts as of _____ will be deferred and _____ % of the deferred amounts credited to the accounts as of _____ and invested in _____ will be deferred. Therefore, the remaining _____ % is to be distributed by _____ and the rest is to be deferred until _____.

1. Tax Year

There were to be two distribution events on tax year _____.

- Records show total distributions for the _____ tax year per Taxpayer's records for the two distribution events were \$ _____. The total distributions in the _____ tax year were supposed to be \$ _____.
- _____ deferral elections show _____ % of the deferrals were to be distributed on _____. Foreign Corporation's Audited Financials show a total deferral balance of \$ _____ as of _____.
 - _____ % x _____ = _____ is what should have been distributed on _____ per the _____ deferral election. Foreign Corporation's Audited Financials show \$ _____ was transferred from Foreign Corporation to Taxpayer in _____.
- _____ deferral election shows _____ % of the deferrals were to be distributed by _____. Foreign Corporation's Audited Financials show a total deferral balance of \$ _____ as of _____ [\$ _____ (total deferral balance as of _____) - _____ (less total distributions made on _____ per the Foreign Corporation's Audited Financials) _____ (plus earnings/appreciation as of _____) = \$ _____].
 - _____ % x \$ _____ = _____ is what should have been distributed per the deferral election. Records show \$ _____ was transferred from Foreign Corporation to Taxpayer in _____.

2. Tax Year

- The _____ deferral election states _____ % of the deferral balance should be

distributed during tax year . The Foreign Corporation Audited Financials shows a total deferral balance of \$ as of (\$ of total deferral balance as of + \$ appreciation as of).

o % x = \$ is the total that should have been distributed in per the special deferral election.

- The total distributions for the tax year per Taxpayer's records were \$.^[1] The total distributions in the tax year were supposed to be \$.

- **Tax Year**

- The deferral election states a % of the deferral balance was to be distributed by . The Foreign Corporation Audited Financials shows the total deferral balance as of is \$ (\$ total deferral balance as of + \$ appreciation as of).

- % x = \$, this is the total that should have been distributed in per the deferral election. Records show the \$ was actually transferred from Foreign Corporation to Taxpayer in ^[2]

The total distributions for the tax year per Taxpayer's records were \$. The total distribution that was supposed to be distributed in the tax year was supposed to be \$.

- **3. Tax Year**

- The deferral election required % of the remaining deferred fees to be distributed by . On , Taxpayer opted to re-defer % of the deferred fees (the balance determined as of) until . Therefore % of the deferrals were required to be distributed by . The Foreign Corporation Audited Financial Statements shows a total deferral balance of \$ as of (\$ as of +\$ appreciation as of).

^[1] Records used to verify that this information the amount transferred from Foreign Corporation to Taxpayer are bank statements from both entities, Taxpayer's Form 1120S, the Repatriated Deferred Fees, and the Foreign Corporation Audited Financial Statements.

^[2] Records used to verify that this was the amount transferred from Foreign Corporation to Taxpayer are bank statements from both entities, Taxpayer's Form 1120S, an excel called " " which is supposed to show deferred fees coming into Taxpayer's accounts," and the Foreign Corporation Audited Financial Statements

\$ _____ x _____ %=\$ _____, this is the total that should have been distributed in _____ per the _____ re-deferral. Records show \$ _____ was distributed in _____.

LAW AND ANALYSIS

Section 409A(a)(1)(a) provides that a plan must meet the requirements of paragraphs (a)(2), (a)(3), and (a)(4) and the plan must be operating in accordance with such requirements. Section 409A(a)(2)(A) provides that compensation deferred under a plan may not be distributed earlier than the death, disability, or a date set forth in the plan. Deferred compensation subject to section 409A may be paid only upon the occurrence of certain events (e.g., death, disability, separation from service) or on a fixed date set forth in the plan. Treas. Reg. §1.409A-3(a). Thus, deferred compensation amounts must be paid on the dates set forth in the plan, and accelerated payments and delayed payments are generally not permissible. Section 1.409A-3(j)(1) provides that the acceleration of payments provided under a plan is not permitted. Section 1.409A-2(b)(1) provides a plan may not delay a payment unless an election is made to delay the payment at least 12 months before the payment is scheduled to be made and the payment is delayed at least five years beyond the date the payment was originally scheduled to be made. Under §1.409A-3(d), if a plan sets forth fixed payment dates, an actual payment may be made 30 days before or the specified date or until the end of the service provider's taxable year in which the specified date or event occurs. If the service provider's taxable year ends less than 2 ½ months following the specified payment date, the payment can be made by the 15th day of the third month after the specified date. Here, payments were not made at the time set forth in the USR Plan. Therefore, the USR Plan was not operated in accordance with the requirements of section 409A(a). Accordingly, all compensation deferred under the plan for the taxable year and all preceding taxable years is includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

ISSUE 3

Employee A separated from service on or about _____, and Taxpayer accelerated vesting of the amount owed to A under the ISR Plan. Taxpayer paid the amount to Employee A pursuant to the terms of the ISR Plan, but Foreign Corporation did not pay an amount equal to the amount paid to A to Taxpayer as required under the USR Plan and Taxpayer did not include this amount in income. Did the USR Plan fail to meet the requirement of section 409A(a)(1)(A) that a plan be operated in accordance with the requirements of section 409A(a)(2)?

CONCLUSION

Yes. The USR Plan was not operated in accordance with the requirements of section 409A(a)(2) because the USR Plan did not pay Taxpayer an amount equal to the

amount paid to Employee A, as required under the terms of the USR Plan. Therefore, the USR Plan failed to meet the requirements of section 409A(a).

FACTS

Employee A was a service provider who performed service for Taxpayer and who separated from service on or about . Under the ISR Plan, Taxpayer had the discretion to deem unvested amounts as vested upon a separation from service of a participant. The ISR Plan states that if the Taxpayer exercises this discretion, Taxpayer will distribute such amounts to a former employee on the last day of the thirteenth month following the employee's separation of service. Taxpayer chose to accelerate vesting for Employee A upon A's separation from service. Taxpayer and Employee A executed a separation agreement memorializing this understanding. Payroll records show Taxpayer paid Employee A \$ in on or about the last day of the thirteenth month following the separation from service. However, Foreign Corporation did not pay \$ to Taxpayer in and Taxpayer did not include this amount in income.

LAW AND ANALYSIS

As discussed above, a plan must meet the requirements of paragraphs (a)(2), (a)(3), and (a)(4) of section 409A, and the plan must be operated in accordance with these requirements. Amounts must be paid on the dates set forth in the plan, and thus accelerated payments and delayed payments are generally not permissible. Section 409A(a)(2)(A) provides that compensation deferred under a plan may not be distributed earlier than the death, disability, or a date set forth in the plan. Treas. Reg. § 1.409A-3(a) provides that a payment from a plan may be made only upon the occurrence of certain events, one of which is a separation of service of a participant. Under Treas. Reg. § 1.409A-3(i)(6), payments under an ultimate service recipient plan to the intermediate service provider must match the payments made under the intermediate service recipient plan to the ultimate service provider. Here, the terms of the USR Plan were not followed and Foreign Corporation did not pay an amount equal to the amount paid to Employee A. Therefore, in the USR Plan was not operated in accordance with the requirements of section 409A(a). Accordingly, all compensation deferred under the plan for the taxable year and all preceding taxable years is includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

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Please call (202) 622-6030 if you have any further questions.

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