King & Spalding

Compensation and Benefits Insights

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IRS Issues 409A Guidance on "Back-to-Back" Arrangements

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On June 23, 2017, the IRS Office of Chief Counsel (the "IRS") released an advice memorandum (the "Memorandum") addressing the application of Section 409A of the Internal Revenue Code of 1986, as amended ("Section 409A") to a "back-to-back" arrangement (as described below). The IRS concluded that the "back-to-back" arrangement did not meet the requirements of Section 409A. The Memorandum serves as a good reminder to any employer who offers (or participates in) such a "back-to-back" arrangement to review its terms and operation for potential Section 409A noncompliance.

Background

Section 409A only permits amounts deferred under a nonqualified deferred compensation plan to be paid on the occurrence of one of the following permissible payment events: the service provider's separation from service, disability, death, a time or fixed schedule set out in the deferred compensation plan, a change in control event, or the occurrence of an unforeseeable emergency.

Generally speaking, a payment to a service provider generally cannot be triggered by the separation from service of another service provider. However, an exception exists in the Section 409A regulations for "back-to-back" arrangements that meet the requirements of those regulations (i.e., Treas. Reg. §1.409A-3(i)(6)). Under the exception, a deferred compensation plan of an "ultimate service recipient" ("USR") may provide for a payment to an "intermediate service recipient" ("ISR") on the occurrence of a permissible payment event under the ISR's deferred compensation plan if:

- The time and form of payment is defined as the same time and form of payment provided under the ISR plan.
- The amount of the payment under the USR plan does not exceed the amount of the payment under the ISR plan.

Our Practice

We advise public, private, taxable and tax-exempt clients on a wide variety of issues related to the design, preparation, communication, administration, operation, merger, split-up, amendment and termination of all forms of employee benefit plans and executive compensation programs and related funding vehicles. The firm has defended clients in significant high-profile ERISA litigation matters, including 401(k) plan "stock drop" cases and other breach-of-fiduciary-duty class actions.

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- The USR plan and the ISR plan otherwise satisfy the requirements of Section 409A.

Facts

In the Memorandum, Taxpayer is a United States taxpayer that manages many investment funds, both overseas and in the United States, including the foreign investment fund at issue ("Foreign Corporation"). According to the Memorandum, 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 performing management and investment advisory services for Taxpayer ("Participants"). For purposes of Section 409A, Foreign Corporation is considered the USR, and Taxpayer is considered the ISR.

Foreign Corporation and Taxpayer were parties to a deferred compensation arrangement (the "USR Plan") under which Taxpayer deferred some of its management fees and/or performance fees. Taxpayer in turn sponsored a deferred compensation arrangement (the "ISR Plan") for the Participants. The USR Plan and the ISR Plan were intended to be "back-to-back" arrangements for purposes of Section 409A. 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, in general, 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.

Although the ISR Plan and the USR Plan were set up in a manner designed to satisfy Section 409A's "back to back" arrangement exception, the IRS found that the USR Plan failed to meet the requirements that apply to back-to-back arrangements under Section 409A, for several reasons. We'll discuss each reason in turn.

Problematic Issues Discussed in the Memorandum

Issue #1: Payments under the USR Plan Exceeded Payments under the ISR Plan

The USR Plan provided that a payment of deferred compensation was to be made to Taxpayer even when an amount was forfeited by a Participant under the ISR Plan. As a result, payments to the Taxpayer under the USR Plan would be made in connection with a Participant's separation from service, but there would be no corresponding payment from the Taxpayer to the Participant. Because payments to the Taxpayer under the USR Plan could exceed the payments made to the Participant under the ISR Plan, this provision resulted in an impermissible payment event under Section 409A.

Issue #2: Payments under the USR Plan Were Not Made at the Time and in the Amount Specified in the USR Plan

Taxpayer had made "special deferral elections" under the USR Plan, and elected to be paid deferred compensation on certain dates and in certain amounts over several tax years. However, in some tax years, the payments that were actually made were less than the amounts called for under the USR Plan, and in other tax years the payments that were actually made were more than the amounts called for under the USR Plan. Accordingly, the IRS found that the USR Plan was not

being operated in accordance with Section 409A's requirement that payments under a plan be made at the time specified in the plan, and in the amount specified in the plan.

Issue #3: Payments Under The USR Plan Did Not Match the Payments Made Under the ISR Plan

According to the Memorandum, one of the Participants had a separation from service with Taxpayer at some point in time. 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 stated that if Taxpayer exercised that discretion, Taxpayer was required to distribute such amounts to a former Participant on the last day of the 13th month following the Participant's separation of service. The Memorandum states that Taxpayer chose to accelerate vesting for the Participant in question upon the Participant's separation from service, and that Taxpayer and the Participant executed a separation agreement memorializing their understanding. According to the Memorandum, payroll records showed that Taxpayer paid the Participant the amounts in question on or about the last day of the 13th month following the Participant's separation from service (in accordance with the terms of the ISR Plan). However, Foreign Corporation did not pay an amount to Taxpayer equal to the amount paid to the Participant, which it was required to do under the terms of the USR Plan. The IRS found that because the terms of the USR Plan were not followed, the USR Plan was not operated in accordance with the requirements of Section 409A (which require, in relevant part, that payments under the USR Plan to the ISR must match the payments made under the ISR Plan to the USR).

Consequences of Failing to Comply with Section 409A

The IRS concluded that a Section 409A violation occurred in connection with each of the three issues raised in the Memorandum. Failure to comply with Section 409A's requirements results in adverse tax consequences, including the following:

- Deferred compensation is included in income when it vests.
- A 20% penalty tax is imposed on the amount involved.
- An increased interest rate is imposed on the late payment of the income tax due on the compensation.

Conclusions

The problematic issues discussed in the Memorandum serve as a great reminder that "back-to-back" arrangements must not only be *designed* in a manner that complies with Section 409A's requirements, but must also be *administered*, on an ongoing basis, in a manner that complies with Section 409A's requirements. Of the three issues discussed in the Memorandum, two of the issues (Issues #2 and #3) could have been avoided simply by following the terms of the plans' documents, and the third could have been avoided by confirming at the time the plans were designed that the plans' terms complied with Section 409A's requirements. King & Spalding's attorneys are familiar with the complexities that are unique to such "back-to-back" arrangements, and would be happy to advise you on structuring and operating such arrangements in compliance with Section 409A.

August and September 2017 Filing and Notice Deadlines for Qualified Retirement and Health and Welfare Plans

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Employers and plan sponsors must comply with numerous filing and notice deadlines for their retirement and health and welfare plans. Failure to comply with these deadlines can result in costly penalties. To avoid such penalties, employers should remain informed with respect to the filing and notice deadlines associated with their plans.

The filing and notice deadline table below provides key filing and notice deadlines common to calendar year plans for the next two months. If the due date falls on a Saturday, Sunday, or legal holiday, the due date is generally delayed until the next business day. Please note that the deadlines will generally be different if your plan year is not the calendar year. Please also note that the table is not a complete list of all applicable filing and notice deadlines (including any available exceptions and/or extensions), just the most common ones. King & Spalding is happy to assist you with any questions you may have regarding compliance with the filing and notice requirements for your employee benefit plans.

Deadline	Item	Action	Affected Plans
August 14 (within 45 days after the close of the second quarter of plan year)	Benefit Statements for Participant-Directed Plans	Deadline for plan administrator to send benefit statement for the second quarter of the plan year to participants in participant-directed defined contribution plans.	Defined Contribution Plans with participant-directed investments
	Quarterly Fee Disclosure	Deadline for plan administrator to disclose fees and administrative expenses deducted from participant accounts during the second quarter of the plan year. Note that the quarterly fee disclosure may be included in the quarterly benefit statement or as a stand-alone document.	

Deadline	Item	Action	Affected Plans
August 15 (the 15th day of the 8th month after the end of the plan year)	IRS Forms 990 and 990-EZ	Deadline for tax-exempt trusts associated with qualified retirement plans and voluntary employee beneficiary associations (VEBAs) to file Forms 990 or 990-EZ with the IRS for prior year if the trustee obtained a 3-month extension by filing a Form 8868.	Qualified Retirement Plans* Voluntary Employee Beneficiary Associations
September 15 (8 ½ months after the end of the plan year)	Minimum Contribution Deadline	Deadline for plan administrator to contribute balance of minimum contributions necessary to avoid a funding deficiency.	Defined Benefit Plans
September 30 (within 9 months of the end of the plan year)	Summary Annual Report (SAR)	Deadline for plan administrator to distribute Summary Annual Report for prior year to participants and beneficiaries. This deadline may be extended until 2 months following the close of the extension period for filing a Form 5500, if applicable.	Defined Contribution Plans Health and Welfare Plans (unfunded welfare plans are exempt)
September 30 (last day of the 9th month following the end of the prior plan year)	Certification of Adjusted Funding Target Attainment Percentage (AFTAP)	Deadline for actuary to certify AFTAP to avoid presumption that AFTAP is less than 60%.	Defined Benefit Plans

* Qualified Retirement Plans include all defined benefit and defined contribution plans that are intended to satisfy Internal Revenue Code §401(a).