Office of Chief Counsel
Internal Revenue Service
Memorandum

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from: Deputy Division Counsel/Deputy Associate Chief Counsel (Employee Benefits)
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subject: Request for advice regarding change in accounting method by a section 457A nonqualified entity

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

ISSUE

May a service provider making an overall accounting method change under section 446(e) of the Code -- from the cash receipts and disbursements method of accounting to an accrual method of accounting -- include in its adjustment under section 481(a) ("section 481(a) adjustment") vested deferred compensation under a plan of a nonqualified entity that would have been includible under section 457A had the services not been performed before January 1, 2009, resulting in some of the vested deferred compensation being included in income later than the service provider's last taxable year beginning before 2018?

CONCLUSION

To the extent the section 481(a) adjustment relates to vested deferred compensation that is attributable to services performed before January 1, 2009, under a plan of a nonqualified entity, the service provider may not take the

adjustment into account later than the service provider's last taxable year beginning before 2018.

FACTS (FOR ILLUSTRATION PURPOSES)

To illustrate the application of section 457A, assume the following facts. Service Recipient is a foreign corporation and a nonqualified entity described under section 457A(b). Service Provider is treated as a partnership for U.S. income tax purposes. Service Provider has continually provided services to Service Recipient since 2005. Service Provider elected each year to defer a portion of its annual compensation for services to Service Recipient under a nonqualified deferred compensation plan of Service Recipient. Service Provider elected to defer compensation for services performed before January 1, 2009 until December 31, 2017. Service Provider's deferral of compensation was not subject to a substantial risk of forfeiture (as defined under section 457A(d)(1)), complied with the requirements of section 409A, and was not otherwise includible in Service Provider's income before the change in accounting method.

For all taxable years before 2016, Service Provider used the overall cash receipts and disbursements method of accounting for U.S. Federal income tax purposes, with the calendar year as its taxable year. Service Provider filed a Form 3115, Application for Change in Accounting Method, requesting permission to change its overall method of accounting to an accrual method of accounting for the taxable year beginning January 1, 2016. Service Provider's change in accounting method resulted in a positive section 481(a) adjustment.

You ask whether Service Provider may take the section 481(a) adjustment into account over a four-year adjustment period under section 481(c), beginning on January 1, 2016 and ending on December 31, 2019, even though a portion of the adjustment relates to deferred compensation attributable to services performed before January 1, 2009.

LAW AND ANALYSIS

Section 457A(a) provides that any compensation that is deferred under a nonqualified deferred compensation plan of a nonqualified entity is includible in the service provider's gross income when there is no substantial risk of forfeiture of the rights to the compensation.

Section 457A(b) defines the term "nonqualified entity" as (1) any foreign corporation unless substantially all of its income is (A) effectively connected with the conduct of a trade or business in the United States, or (B) subject to a comprehensive foreign income tax; and (2) any partnership unless substantially all of its income is allocated to persons other than (A) foreign persons with respect to whom such income

is not subject to a comprehensive foreign income tax, and (B) organizations which are exempt from tax under the Code.

Section 457A(d)(3)(A) defines the term "nonqualified deferred compensation plan" as generally having the meaning provided under section 409A(d). Section 409A(d) provides that the term "nonqualified deferred compensation plan" means any plan that provides for the deferral of compensation.

Section 457A was added to the Code by section 801(a) of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Pub. L. No. 110-343 (Div. C), 122 Stat. 3929 (2008) (TEAMTRA). Section 801(d)(1) of TEAMTRA provides that "the amendments made by this section shall apply to the amounts deferred which are attributable to services performed after December 31, 2008." Section 801(d)(2) provides a transition rule under which "any amount deferred to which the amendments made by this section do not apply solely by reason of the fact that the amount is attributable to services performed before January 1, 2009 [(pre-2009 deferred compensation)] shall be includible in gross income in the later of – (A) the last taxable year beginning before 2018, or (B) the taxable year in which there is no substantial risk of forfeiture of the rights to such compensation … ." Your inquiry relates to deferred compensation (as described in section 457A) as of January 1, 2009, that was not subject to a substantial risk of forfeiture as of January 1, 2009. Therefore, the sole reason that these amounts were not includible in income under section 457A is that the amounts were attributable to services performed before January 1, 2009. As a result, these amounts must be included in taxable income no later than the last taxable year beginning before 2018.

Section 1.409A-1(f) provides that a service provider is a person who accounts for gross income from the performance of services on the cash method of accounting. Based on this, we understand that some taxpayers have argued that the amount deferred is no longer subject to section 457A in 2017, and therefore, the amount is not subject to the income inclusion requirements of section 801(d)(2) of TEAMTRA.

This argument fails for two reasons. First, amounts deferred may be subject to section 457A even if Service Provider is a taxpayer using an accrual method of accounting. As Notice 2009-8, Q/A-5 (2009-4 I.R.B. 347) provides, "A service provider may be subject to section 457A regardless of whether such person accounts for gross income from the performance of services under the cash receipts and disbursements method of accounting or under [an] accrual method of accounting." A Joint Committee on Taxation report explains that for purposes of section 457A, "[t]he term service provider has the same meaning as under the regulations under section 409A except that whether a person is a service provider is determined without regard to the person's method of accounting." JCX-75-08 (Sept. 25, 2008).

In addition, the requirement to include these amounts in income in accordance with section 801(d)(2) of TEAMTRA does not require that the amounts be subject to section 457A at the time of the income inclusion. Rather, that special income inclusion rule applies if, as of the later of (1) January 1, 2009 (the effective date of the addition of

section 457A of the Code), or (2) the date the deferred amounts were no longer subject to a substantial risk of forfeiture, the sole reason that the amounts were not includible in income under section 457A was due to application of the grandfathering provision of section 803(d)(1) of TEAMTRA (meaning that the amounts were attributable to services performed before January 1, 2009). In this case the taxpayer used the cash receipts and disbursements method of accounting at the later of the time these amounts were no longer subject to a substantial risk of forfeiture or January 1, 2009, so that the taxpayer's arguments concerning its current use of the accrual method of accounting is not relevant. Rather, the amounts of deferred compensation were described in section 457A at the relevant times and absent application of the grandfathering rules under section 801(d)(1) of TEAMTRA, those amounts would have been includible in income under section 457A. As provided in section 801(d)(2) of TEAMTRA, because the sole reason these amounts were not includible in section 457A during those earlier periods is that the amounts were attributable to services performed before January 1, 2009 (so that the special grandfathering rules under section 801(d)(1) of TEAMTRA applied), those amounts must be included in income no later than the later of the last taxable year beginning before 2018 or the first taxable year in which the amounts were no longer subject to a substantial risk of forfeiture, as provided under section 801(d)(2) of TEAMTRA).

The next issue is whether the change in accounting method may result in a portion of the amount being included in income after a taxpayer's last taxable year beginning before 2018 due to a generally available four-year adjustment period. Section 446(e) provides that a taxpayer that changes its method of accounting on the basis of which it regularly computes its income in keeping its books shall, before computing its taxable income under the new method, secure the consent of the Secretary.

Section 1.446-1(e)(2)(ii)(a) provides that a change in accounting method includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in such overall plan. A "material item" includes "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction."

Section 481(a) provides that in computing the taxpayer's taxable income for any taxable year (the year of change), if such computation is under an accounting method different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

Section 3.16 of Rev. Proc. 2015-13 (2015-5 I.R.B. 419) provides that the section 481(a) adjustment period is the number of taxable years that the taxpayer takes into

account the section 481(a) adjustment required as a result of the change in method of accounting, beginning with the year of change. Under section 7.03 of Rev. Proc. 2015-13, the section 481(a) adjustment period is generally one taxable year (the year of the change) for a negative section 481(a) adjustment and four taxable years (the year of the change and next three taxable years) for a positive section 481(a) adjustment. In the case of a letter ruling granting a non-automatic change, the IRS may provide a different section 481(a) adjustment period.

Service Provider's pre-2009 deferred compensation was deferred under a nonqualified deferred compensation plan of a nonqualified entity, and would otherwise have been subject to section 457A (and includible in gross income) when the statute became effective on January 1, 2009, except that the deferred compensation related to pre-2009 services. Therefore, the pre-2009 deferred compensation must be included in taxable income no later than the Service Provider's last taxable year beginning before 2018. By using the generally applicable four-year § 481(a) adjustment period, Service Provider would include one-fourth of its pre-2009 deferred compensation in gross income for its 2016 taxable year. Section 801(d)(2) of TEAMTRA requires that the remaining three-fourths of the pre-2009 deferred compensation be included in the Service Provider's gross income for its 2017 taxable year so that all of the pre-2009 deferred compensation is included in gross income no later than Service Provider's last taxable year ending before 2018.

Inclusion of one-fourth of Service Provider's pre-2009 deferred compensation in 2016 and three-fourths of that deferred compensation in 2017 is required irrespective of any administrative guidance to the contrary. Allowing taxpayers to apply administrative guidance under a statute of general application and use a section 481(a) adjustment period that extends beyond 2017 would conflict with section 801(d)(2) of TEAMTRA, a statute of specific application indicating a particular deadline for income inclusion. The courts give precedence to the terms of a more specific statute in cases in which a general statute and a specific statute both address an issue. See, e.g., Hinck v. United States, 550 U.S. 501, 506 (describing the "well-established principle" that "a precisely drawn, detailed statute preempts more general remedies" (internal quotation marks and citations omitted)); Radzanower v. Touche Ross & Co., 426 U.S. 148, 153 (1976) ("Where there is no clear intention otherwise, a specific statute will not be controlled or nullified by a general one, regardless of the priority of enactment." (quoting Morton v. Mancari, 417 U.S. 535, 550–51 (1974)). Therefore, under section 801(d)(2) of TEAMTRA, the Service Provider must include the remaining three-fourths of the pre-2009 compensation in its gross income for its 2017 taxable year.

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

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