INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.:

Director of Field Operations / LMSB:RFP

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
Organization =
Group =
Association =
Employees =
a =
b =
$d =
$e =
$f =
$g =
$h =
$k =
$m =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =

Date 6 =

ISSUE(S):

Whether the Taxpayer may deduct amounts paid to the Association for deposit into a strike fund.

CONCLUSION:

The Taxpayer may not deduct amounts paid to the Association for deposit into a strike fund. The Taxpayer's contributions serve to create or enhance for the Taxpayer what is essentially a separate and distinct asset. Rev. Rul. 82-15 is distinguishable.

FACTS:

The Taxpayer, an Organization of the Group, files its returns using the accrual method of accounting. The Taxpayer and the other a Organizations that comprise the Group are members of the Association, an unincorporated, not-for-profit association exempt from federal income tax as a business league under section 501(c)(6) of the Internal Revenue Code. The Association acts as the collective bargaining representative of its members in their negotiations with Employees employed by the members.

In Year 1, the members of the Association established a $d line of credit with banks in order to provide loans to members in the event of a strike by the Employees. In fact, a long strike occurred in Year 1 and b members made use of the credit line by borrowing approximately $e per member.

In Year 2, the members contemplated replacing the credit line with their own internal strike fund. The members anticipated that an internal strike fund would provide certain benefits, including (1) guaranteed access to market rate loans; (2) elimination of expensive borrowing fees, including loan arrangement fees, commitment fees, and legal fees; and (3) elimination of conditions that were imposed on the previous bank borrowings, such as joint and several liability among the various members and restrictions on other borrowings.

The members authorized the establishment of the strike fund on Date 1. On that date, a mandatory annual assessment of $f per member was imposed to finance the fund. By resolution dated Date 2, the members unanimously resolved to increase the annual assessment to $g per member. By resolutions dated Date 3, and Date 4, the members unanimously resolved to suspend the $g planned assessment for Year 3 and Year 4, respectively.

Prior to Year 4, there was no written policy governing the operation of the fund.

However, on Date 5, the Association adopted a resolution setting forth the governing provisions of the fund. In relevant part, this resolution provides as follows:

1) The sole purpose of the strike fund shall be to provide loans to members in the event of an Employee strike or work stoppage;
2) The strike fund shall consist of amounts collected from members through mandatory assessments specifically designated as imposed for the strike fund, and any earnings accruing on those amounts;
3) The strike fund shall constitute an asset of the Association, and members shall have no property interest or other transferable interest in the assets of the fund;
4) All members in good standing who experience an Employee strike or work stoppage during or after Year 4 shall be eligible to apply for a loan from the strike fund;
5) Members seeking a loan must demonstrate that without a loan the strike or work stoppage will cause the member to be unable to continue its operations and to bargain in good faith;
6) The creditworthiness of a member applying for a loan shall be evaluated using criteria similar to those that would be applied by a commercial lending institution, and in no event shall loan eligibility or the amount of a loan bear any relationship to the assessments paid to the strike fund by the borrowing member;
7) Repayment of strike fund loans shall be enforced in the same manner as repayment of a commercial loan, including through collection procedures, and any member that defaults on repayment of a strike fund loan may be suspended from the Association;
8) If the requisite number of members votes to terminate the strike fund, any amounts in the fund at the time of termination shall be retained by the Association to be used solely in furtherance of its exempt purposes.

The strike fund made no loans to its members during the period from Year 2 (the inception of the fund) through Year 6 (the taxable year at issue).

In Year 5 the Taxpayer and the other members of the Group entered into a court-approved agreement settling long-standing litigation brought against them by the Employees. This agreement obligated the members to make settlement payments to the Employees in an amount totaling $h. The members voted unanimously to use the assets of the strike fund to satisfy part of their individual payment obligations under the settlement agreement. The entire balance in the strike fund (an amount in excess of $k) was used to satisfy part of the members' $h obligation to the Employees. The Taxpayer acknowledges that this use of fund assets was not a loan from the fund.

In Year 6 a strike fund assessment in the amount of $m per member was levied by the Association. The Taxpayer paid this assessment on Date 6, and deducted the assessment in its income tax return as an ordinary and necessary business expense.

LAW AND ANALYSIS:

Section 162 of the Code generally allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Section 1.162-15(c) of the Income Tax Regulations specifically provides that dues and other payments to a trade association that otherwise meet the requirements of the regulations under section 162 are deductible in full.

Section 263(a) of the Code provides that no deduction shall be allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property. Section 1.263(a)-2(a) of the regulations clarifies that section 263 requires capitalization of costs incurred to acquire property having a useful life substantially beyond the close of the taxable year.

The Code's capitalization provisions take precedence over its deduction provisions. See §§ 161, 261. Thus, an expenditure that would ordinarily be a deductible expense must nonetheless be capitalized if it is incurred in connection with the acquisition of a capital asset. Commissioner v. Idaho Power Co., 418 U.S. 1, 17 (1973); Ellis Banking Corp. v. Commissioner, 688 F.2d 1376, 1379 (11th Cir. 1982). While there is no readily available formula for determining in every context whether a particular expenditure is a deductible current expense or a nondeductible capital expenditure, the Supreme Court has held that an expenditure must be capitalized if it creates or enhances a separate and distinct asset or otherwise provides significant future benefits for the taxpayer. Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971); INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87 (1992).

The field contends that the issue here is governed by Lincoln Savings. The field asserts that the members of the Association maintain a property interest in the assets of the strike fund, and that contributions to the fund are therefore nondeductible capital expenditures.

In Lincoln Savings, the Supreme Court considered whether certain premiums, required by federal statute to be paid by a savings and loan association to the Federal Savings and Loan Insurance Corporation (FSLIC), were ordinary and necessary business expenses. The Court found that the premiums, the purpose of which was to provide FSLIC with a secondary reserve fund for the protection of account holders of the insured institutions, "serve[d] to create or enhance for Lincoln what is essentially a separate and distinct additional asset." 403 U.S. at 354. The Court concluded that an expenditure that creates or enhances a separate and distinct asset is a capital expenditure, and not an ordinary and necessary expense.

In reaching its conclusion, the Court found that contributions to the secondary reserve were not available to fund the day-to-day operations of the FSLIC, but were held for the stated and circumscribed purpose of paying losses of account holders of

the insured institutions. The Court also relied heavily on its finding that the insured institutions retained a property interest in the secondary reserve. The Court identified various facts evidencing the existence of this property interest. First, an insured institution's share of the secondary reserve was transferable in the case of merger, asset transfer, or other similar transaction. Second, an insured institution could receive a refund of its share of the secondary reserve if its status as an insured was terminated, if it liquidated, or if other reserves of FSLIC exceeded certain thresholds. Third, an insured institution's share of the secondary reserve could be used to discharge other obligations of the institution in certain circumstances. Fourth, a separate account was maintained on the books of FSLIC for each insured institution's share of the secondary reserve. Finally, the secondary reserve earned an annual return, and thus was an income-producing entity, and such income inured to the benefit of the insured institutions.

The Taxpayer does not agree that Lincoln Savings controls the result here. The Taxpayer contends that it maintains no property interest in the assets of the strike fund, and that the strike fund assessments constitute a temporary increase in membership dues that allow the Association to provide an additional service to members in the form of strike loans. The Taxpayer notes that Rev. Rul. 82-15, 1982-1 C.B. 29, specifically allows a deduction for contributions to a strike fund.

In Rev. Rul. 82-15, members paid an increased dues charge to a trade association exempt from tax under section 501(c)(6) of the Code. The trade association represented its members in collective bargaining with a labor union, and implemented the increased charge to establish a loan fund for the sole purpose of providing loans to members experiencing a labor strike. Any amounts remaining in the loan fund upon termination of the fund were to be used in furtherance of the trade association's exempt purposes.

The ruling concludes that the additional dues charges are ordinary and necessary expenses because they do not result in the acquisition by the members of any permanent interest in property. According to the ruling, the payments entitle the members to the benefits of continued membership in the trade association, including eligibility to participate in the strike loan fund, and the payments are therefore deductible as dues or other payments to a trade association under section 1.162-15(c) of the regulations.

Rev. Rul. 82-15 is based on the clearly stated premises that the strike fund would be used only to make loans to members in the event of a strike, and that if the fund terminated contributions would not revert to the members. These facts support the conclusion that the members maintain no property interest in the fund, and the contributions to the fund are therefore deductible as ordinary and necessary expenses under section 162.

The facts here are distinguishable from Rev. Rul. 82-15. The governing terms of the Association strike fund provide that the fund shall be used solely to make loans to members, the members shall have no property interest in the assets of the fund, and any amounts remaining in the fund upon termination shall be retained by the Association to be used solely in furtherance of its tax exempt purposes. Despite these provisions, the members voted unanimously in Year 5 to use all of the accumulated contributions in the fund (and the earnings thereon) to satisfy their individual obligations to the Employees under the settlement agreement. In our view, this use of fund assets to satisfy the individual obligations of the members is inconsistent with the fund's governing provisions, with Rev. Rul. 82-15, and potentially with the proscription against private inurement contained in section 501(c)(6) of the Code.

The Taxpayer does not agree that the use of the strike fund to satisfy members' individual obligations is inconsistent with the fund's governing provisions or with Rev. Rul. 82-15. The Taxpayer notes that both Rev. Rul. 82-15 and the governing provisions of the Association strike fund permit the Association, upon termination of the fund, to use the fund assets in furtherance of the Association's exempt purpose. The Taxpayer contends that the fund terminated when all of its assets were distributed in Year 5 to satisfy the obligations of the members under the settlement agreement. The Taxpayer further contends that the use of fund assets to satisfy member obligations under the settlement agreement is consistent with the Association's exempt purpose of promoting labor peace in the Group.

We do not agree that the strike fund terminated upon distribution of its assets in Year 5. Indeed, the Taxpayer acknowledges that the governing provisions of the fund remained effective in Year 6 when the Taxpayer made the strike fund contribution at issue here. We think this fact alone undercuts the Taxpayer's argument that the fund terminated in Year 5. Further, even assuming the fund did terminate in Year 5, we do not agree that the use of the fund assets to satisfy the members' individual obligations under the settlement agreement is consistent with the exempt purpose of the Association. The exempt purpose of the Association, according to its articles of association, is to act on a non-profit basis as the representative of the members in the conduct of collective bargaining and other Employee relations activities of mutual interest to all its members. We view the use of the fund's assets to satisfy the legal obligations of individual members as outside the scope of the Association's exempt purpose. For these reasons, we conclude that Rev. Rul. 82-15 is distinguishable on its facts and does not control the result here.

In our view, the strike fund resembles the secondary reserve in Lincoln Savings that was determined by the Supreme Court to constitute a separate and distinct asset of the insured institutions. As in Lincoln Savings, the members' contributions to the strike fund were not available for the general use of the Association. Rather, such contributions were to be used solely to provide a strike fund for the members. By using their contributions to the fund (and the earnings thereon) to satisfy their individual

obligations under the settlement agreement, the members have demonstrated that they maintain a property interest in the assets of the fund.

The Taxpayer notes that the use of fund assets to satisfy the members' obligations under the settlement agreement occurred prior to the year at issue here. The Taxpayer contends that a deduction for the strike fund contribution in the year at issue cannot be denied based simply on the mere possibility that in the future strike fund assets might revert to the members. The Taxpayer argues that unless its future right to a refund from the fund is absolute, or the likelihood of a refund is virtually certain, the contribution to the fund is currently deductible. The Taxpayer cites Electric Tachometer Corporation v. Commissioner, 37 T.C. 158 (1961), and Alleghany Corporation v. Commissioner, 28 T.C. 298 (1957), as support for this argument.

Electric Tachometer Corp. and Alleghany Corp. stand for the proposition that an expenditure that is otherwise deductible as an ordinary and necessary expense is not rendered nondeductible because there remains some contingent possibility of future reimbursement. In Electric Tachometer, the Tax Court held that otherwise deductible moving expenses do not become nondeductible simply because of the possibility that the taxpayer will receive reimbursement for such expenses in a later year. Similarly, in Alleghany the court concluded that otherwise deductible expenses for business protection did not become nondeductible merely because the taxpayer had entered into an agreement with a third party that might have resulted in future reimbursement of such expenses.

The Taxpayer's argument is similar to that specifically rejected by the Tax Court and the Supreme Court in Lincoln Savings. The taxpayer in Lincoln Savings claimed that there existed only a remote possibility that it would recover any of its contributions to the secondary reserve fund. Citing Electric Tachometer and Alleghany, the taxpayer argued that a remote possibility of recovery should not prevent it from currently deducting its contributions to the secondary reserve.

The Tax Court in Lincoln Savings noted that Electric Tachometer and Alleghany were of no help to the taxpayer because the taxpayer "failed to establish the necessary initial foundation required by these cases; i.e., that the amount . . . paid by it to the FSLIC in 1963 . . . constituted an ordinary and necessary expense of that year." 51 T.C. at 104-105. The Supreme Court, while not disputing the taxpayer's claim that its chances of receiving a refund were remote, focused on the other benefits gained by the taxpayer as a contributor to the secondary reserve and found it enough that the taxpayer's contributions to the secondary reserve created ". . . a fund capable under certain circumstances of finding its way back to the coffers of the insured institutions." 403 U.S. at 357.

Similarly, the Taxpayer here has failed to establish the initial foundation required by Electric Tachometer and Alleghany: that the contribution to the strike fund

constitutes an ordinary and necessary expense. As discussed above, the fact that the contributions were not available for the general use of the Association, coupled with the members' demonstrated intent to use the strike fund assets to satisfy their individual liabilities, supports the conclusion that the contributions here, like the contributions to the secondary reserve fund in Lincoln Savings, have created a fund capable of finding its way back to the coffers of the Taxpayer and other members of the Group. Where the facts indicate that a taxpayer is contributing to a fund that will potentially benefit the taxpayer in future years (even where such benefit is not certain to materialize), courts have required capitalization of such contributions. Lincoln Savings, supra; Black Hills Corp. v. Commissioner, 73 F.3d 799 (8th Cir. 1996); Jack's Cookie Co. v. United States, 597 F.2d 395, 405-06 (4th Cir. 1979).

Based on the facts presented, we conclude that the Taxpayer's contribution to the strike fund serves to create or enhance for the Taxpayer what is essentially a separate and distinct asset. Accordingly, contributions to the strike fund are not deductible as ordinary and necessary expenses under section 162. Rev. Rul. 82-15 is distinguishable.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.