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Memorandum

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to:

from: John B. Richards
Senior Technician Reviewer, Employment Tax Branch 2 (Employment Tax/Exempt Organizations/Government Entities) (Tax Exempt and Government Entities)

subject:

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

LEGEND

Corporation X =

Corporation X Plan =

ISSUES:

(1) Whether retired insurance agents' rights to renewal commissions under the Corporation X Plan constitute nonqualified deferred compensation plans for purposes of § 3121(v)(2).

(2) If issue (1) is answered in the affirmative, whether agents' rights to renewal commissions for sales of insurance policies were subject to a substantial risk of forfeiture until the customer renewed the policies and paid the renewal premiums on the policies.

(3) Whether the Internal Revenue Service (IRS) should approve Corporation X's refund claims for FICA taxes paid with respect to renewal commissions paid to retired agents.

CONCLUSIONS:

(1) Based on the information submitted, the insurance agents' rights to renewal commissions under the Corporation X Plan constitute nonqualified deferred compensation plans for purposes of § 3121(v)(2).

(2) Based on all of the facts and circumstances in this case, because Corporation X pays renewal commissions on an insurance policy only if the customer renews the underlying insurance policy and pays the renewal premiums, a particular renewal commission on an insurance policy was subject to a substantial risk of forfeiture until the policy was renewed and the customer paid the related renewal premium(s) on that insurance policy. The renewal of the policy and the payment of the renewal premium on the insurance policy are a condition related to the compensatory purpose of the transfer of the right to the renewal commission by Corporation X, and the agent forfeits the right to any renewal commission if the customer does not renew the policy or does not pay the renewal premium.

(3) Because the renewal commissions were subject to a substantial risk of forfeiture as of the dates the agents retired, Corporation X could not take the nonqualified deferred compensation into account for purposes of § 3121(v)(2) on such dates. Accordingly, the IRS should deny Corporation X's refund claims.

FACTS

Corporation X is engaged in the insurance business in the United States. Corporation X sells individual life insurance including variable life, term life, and traditional whole life policies. Corporation X has represented that full-time life insurance sales agents who sell these insurance policies to individuals for Corporation X are statutory employees for purposes of the FICA under I.R.C. § 3121(d)(3).

Under the Corporation X Plan, Corporation X pays its sales agents primarily through commissions for the sale of insurance policies and annuities. Its agents sign contracts (Agent's Agreement) with Corporation X that govern their performance of service and provide for the payment of commissions and other compensation to the agents. Corporation X bases the amount of commissions on the type of policy sold, the initial premium payment amount, and the number of years a particular policy is renewed, if any. Commission and Compensation Schedules that are referenced in the Agent's Agreement provide for the commissions to be paid to the agent. When an agent has sold an insurance policy and Corporation X puts the policy into force, Corporation X pays an agent an initial first-year commission payment based on the premiums for the first year of the policy. If the policy remains in force in a subsequent year, Corporation X pays the agent a "renewal commission" usually equal to a percentage of the renewal premiums to be paid during the subsequent year. The employee may receive a renewal commission under the terms of the plan only if two conditions are satisfied: (1) (a) the agent is either an active sales agent of Corporation X or (b) his or her services have been terminated because of retirement, disability, or death; and (2) the insurance policy is in force on the anniversary date of the policy and the customer pays the renewal premiums. Corporation X generally pays the agent renewal commissions on a policy for a certain number of years. The period during which an agent receives renewal commissions is usually from four to ten years from the effective date of the policy and may vary depending on the type of policy.

The Agent's Agreement provides that no compensation is payable to the agent until the premiums upon which it is based are received by Corporation X. The Agent's Agreement further provides that no compensation shall be paid to the Agent on account of any policy or contract after it has lapsed or after the discontinuance for any reason of premium payments. In addition, where specified in the applicable Commission and Compensation Schedules, compensation previously paid relating to such a policy shall be repaid by the Agent to Corporation X upon demand, and Corporation X has the right to recover all or part of such compensation from any compensation due and thereafter payable to the agent.

The Agent's Agreement provides that Corporation X "reserves the right to alter or modify in its discretion, with respect to business thereafter paid-for, any of the applicable Commission or Compensation Schedules…." Corporation X has represented that when an agent has sold a policy for which premiums have been paid, Corporation X may not change the commission percentage rate for any renewal commissions on the policy.

Corporation X furnishes its agents a handbook, the Corporation X Plan, describing the payment of commissions and the payment of renewal commissions to an agent. When an agent has sold a policy that reaches its first policy anniversary, Corporation X credits the agent with commissions for <u>all</u> the second policy year premiums on that policy. Corporation X repeats this procedure (except for any necessary change in commission rates or premiums) on each succeeding policy anniversary within the renewal commission period. If a policy lapses with some premiums unpaid in a renewal commission year and if Corporation X has credited the agent with commission credit on those unpaid premiums, it will debit the agent's account for the commission credit allowed with respect to the unpaid premiums. If Corporation X credits an agent with the reinstatement of a policy, it will add commission credit for the premiums scheduled to be paid to the end of the current policy year to the agent's accumulated credits. The Corporation X Plan relating to the payment of commissions provides that the agent begins receiving commissions beginning with the week the Agent's Agreement becomes effective.

For a retired agent, Corporation X pays renewal commissions on ordinary life and health insurance policies reaching policy anniversaries within the renewal commission period. Typically, Corporation X pays a retired agent a large amount of renewal commissions in the first year of his or her retirement and the amount decreases as each year passes. There are two primary reasons for the decrease in subsequent years: (1) because Corporation X credits renewal commissions to the agent based on the policy's origination date (rather than an agent's retirement date) and because Corporation X limits the number of years an agent may receive renewal commissions, the number of policies on which renewal commissions will be paid generally decreases each year after retirement; and (2) Corporation X pays each renewal commission payment only if the customer renews the underlying insurance policy, and each year some customers do not renew insurance policies. A policy is not renewed (or lapses) if either the insured dies or if the insured fails to pay the premiums necessary to continue coverage under the policy.

Corporation X does not maintain separate trust accounts or other separate accounts holding financial assets for the commissions credited to its agents, including renewal commissions of agents. Corporation X pays the agents from its general corporate cash account.

Generally, in the insurance industry, most agents' contracts with insurance companies provide for the "vesting" of renewal commissions on policies sold by agents under certain conditions. "Vesting" of an insurance agent's rights to renewal commissions in insurance industry terminology means that, provided the policy is renewed and renewal premiums paid, the insurance company will pay the agent renewal commissions on the policy regardless of whether the services of the agent have been terminated. Contracts with agents may provide for the "vesting" of renewal commissions if the agent's total sales exceed certain levels or if the agent has completed a minimum period of service. See Black and Skipper, Life Insurance (12th Ed. 1994), page 958.

Corporation X has indicated that the renewal commissions paid to its agents "vest" only if the agent's services are terminated by death, retirement, or disability. When an agent retires, Corporation X does not require that the retired agent perform any further services to receive renewal commissions with respect to policies that he or she sold for Corporation X. Otherwise, Corporation X maintains that it pays the renewal commissions to an agent only if the agent is continuing to perform services as a full-time life insurance salesperson with Corporation X when it credits the renewal commission.

Corporation X, like other life insurance companies, has a vital interest in having its agents sell insurance policies that customers will renew. Because of the administrative costs associated with putting a life insurance policy into force, a typical insurance policy must remain in force for a number of years before an insurance company makes any profit on the policy. If a policy lapses (is not renewed) during the first few years the policy is in force, then the insurer incurs a loss on the policy. Thus, in order for a life insurance company to be profitable with respect to the insurance that it sells, it generally needs the sale of policies that policyholders will renew for many years.[1] Id. at 565, 591.

In insurance terminology, the rate at which customers renew insurance policies is referred to as the "persistency rate." The persistency rate is the ratio of the number of policies that continue coverage on a particular date (it may be computed with respect to the anniversary date of the policy, the premium-due date of the policy, or some other date) to the number of policies that were in force as of the comparable date in the

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[1] There are certain products sold by insurance companies that are single premium products, and such products may be priced such that the product would be profitable without the requirement of renewal by the customer. With respect to such products, renewal commissions may not be paid because there are no renewal premiums.

preceding year. Id. at 622. With respect to a life insurance policy, the insurance coverage will not continue if either (1) the policyholder has decided to discontinue coverage and quits paying premiums or (2) the insured dies. Because of the effect on profits discussed in the previous paragraph, insurance companies strive to increase persistency rates. In order to encourage persistency, some insurance policies provide special benefits to a policy holder if the insurance policy remains in force for a certain period of years. Id. at 80.

One of the principal methods used by insurance companies to encourage their agents to sell policies with high persistency rates is to pay portions of agents' commissions as renewal commissions. Insurance companies provide the renewal commission portion of an agent's compensation for the sale of an insurance policy to an agent only when and if the customer renews the policy, rather than providing the entire amount of the agent's commission upon the sale of the policy. Thus, with renewal commissions, insurance companies have designed their compensation schemes to reward an agent selling insurance that will remain in force for many years by directly tying a portion of the agent's compensation to the renewal of the insurance policy. Renewal commissions paid to an active agent have two component compensatory purposes: (1) they provide compensation to the agent for providing ongoing service to the customer in connection with the insurance policy, and (2) they provide compensation to the agent for the initial sale of the insurance policy. Both of these purposes promote the insurance company's goal of having policies that customers renew and that remain in force. When an agent retires, the renewal commissions received after retirement compensate the retiree for the initial sale of the insurance policy and any services provided by the agent prior to retirement in connection with maintaining the insurance policy. Id. at 958.

The agent plays an important role in selling insurance that will have a high persistency rate and that will thus increase the quality of the insurance company's book of insurance. Although insurance companies review insurance applications to determine whether the applicant qualifies for the insurance, the agent is usually able to determine the suitability of the insurance for the applicant based on discussions with the applicant. If an agent has appropriately evaluated the needs of the purchaser in selling the insurance and has sold to a more financially stable consumer, it is more likely that the policy will be renewed and become profitable for the insurance company.[2]

Despite the incentives provided to encourage persistency, many consumers do not renew insurance policies. There are a number of reasons why a policyholder may decide not to renew an insurance policy. The policyholder may lose the financial ability to pay, or decide he or she does not need or want the insurance for personal or financial reasons. The policyholder may become estranged from the original beneficiary of the policy and have no other desired beneficiary. There may be a change in financial circumstances such that life insurance is not needed. The policyholder may decide to

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[2] The taxpayer's awareness of the importance of the individual agent in achieving a high persistency rate is shown in the in which the credits strong policy persistency rates to the caliber of agents and the quality sales they make.

spend money formerly used to pay insurance premiums on other consumer products or services. The policyholder's employer may have insurance that becomes available at a cheaper cost to the policyholder. The policyholder may decide to buy comparable insurance from another agent at another company (because of better price or better service).

Refund Claims

Corporation X filed refund claims relating to all four quarters of tax years through , totaling $, plus interest. In its claims for refund, Corporation X asserts that it should not have withheld and paid FICA tax on the renewal commissions at the time it paid the renewal commissions to its retired agents. Based on the claims and information provided by Corporation X in response to requests during the examination, we understand Corporation X to be claiming that the Corporation X Plan gives the agent the right to future renewal commissions because all required services have been performed as of the date of retirement. Therefore, Corporation X asserts that under § 3121(v)(2) it may treat the renewal commissions that it may eventually pay a retired agent as subject to FICA tax on the retirement date of the agent. Although the amount of renewal commissions is not reasonably ascertainable at the time of retirement, the taxpayer relies on § 31.3121(v)(2)-2(e)(4)(ii)(A) of the Employment Tax Regulations which permits a taxpayer to take into account for FICA purposes an amount deferred under a nonaccount balance plan that is not reasonably ascertainable, provided that such amount is no longer subject to a substantial risk of forfeiture. Based upon this provision, Corporation X contends that it may retroactively aggregate the renewal commissions from all insurance policies sold by a retired agent and assign a fair market value at the date of retirement based upon the discounted value of the entire stream of renewal commission payments the agent is expected to receive, subject to true up at the resolution date. For the years at issue, Corporation X has apparently used the actual renewal commission payment data to retroactively determine the value of renewal commissions as of the date of the agent's retirement, rather than applying a methodology in order to estimate the fair market value on the date of retirement.

LAW AND ANALYSIS

Sections 3101 and 3111 impose FICA taxes on "wages," as that term is defined in § 3121(a). FICA taxes consist of the Old-Age, Survivors, and Disability Insurance tax (social security tax) and the Hospital Insurance tax (Medicare tax). These taxes are imposed both on the employer under § 3111(a) and (b) and on the employee under § 3101(a) and (b). Section 3102(a) provides that the employer must collect the employee portion of FICA tax by deducting the amount of the tax from the wages as and when paid. Section 3121(a) defines "wages" for FICA purposes as all remuneration for employment including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions. Section 31.3121(a)-1(i) provides that remuneration for employment, unless such remuneration is specifically excepted, constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed the services.

Section 3121(b) defines "employment" for FICA purposes as any service, of whatever nature, performed by an employee for the person employing him, with certain specific exceptions. The definition of “employee” for purposes of the FICA includes officers of corporations, employees under the usual common law rules applicable in determining the employer-employee relationship, and statutory employees. Under § 3121(d)(3)(B), statutory employees for purposes of the FICA generally include full-time life insurance salespersons (other than common law employees and officers of a corporation) if the contract of service contemplates that substantially all of such services are to be performed personally by such individual.

Section 3121(a)(1) provides for the maximum wage limitation on the amount of wages paid to any one employee by an employer during a calendar year that are subject to the social security tax portion of FICA tax. The term “wages” for social security tax purposes does not include that part of the remuneration paid by an employer to an employee within any calendar year which exceeds the applicable wage base.

Generally, wages are subject to FICA tax when they are actually or constructively paid. § 31.3121(a)-2(a) of the regulations. However, § 3121(v)(2) provides a special timing rule for nonqualified deferred compensation. Section 3121(v)(2)(A) provides that any amount deferred under a nonqualified deferred compensation plan must be taken into account as wages for FICA purposes as of the later of (1) when the services are performed or (2) when there is no substantial risk of forfeiture of the rights to such amount. Section 3121(v)(2)(B) states that once nonqualified deferred compensation is taken into account as wages under the special timing rule, then neither that amount nor the income attributable to that amount will be again treated as FICA wages.

Section 3121(v)(3) provides that the term “nonqualified deferred compensation plan” means any plan or other arrangement for deferral of compensation other than a plan described in § 3121(a)(5). Section 31.3121(v)(2)-1(b)(1) provides that the term nonqualified deferred compensation plan means any plan or other arrangement, other than a plan described in § 3121(a)(5), that is established (within the meaning of paragraph (b)(2) of this section) by an employer for one or more of its employees and that provides for the deferral of compensation (within the meaning of paragraph (b)(3) of this section).

Section 31.3121(v)(2)-1(b)(3)(i) states that a plan provides for the deferral of compensation with respect to an employee only if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during a calendar year to compensation that has not been actually or constructively received and that, pursuant to the term of the plan, is payable in a later year. An employee does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the employer after the services creating the right to the compensation have been performed. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of an objective provision creating a substantial risk of forfeiture (within the meaning of § 83). Similarly, an employee does not fail to have a legally binding right to compensation merely because the amount of compensation is determined under a formula that provides for benefits to be offset by benefits provided under a plan that is qualified under § 401(a), or because benefits are reduced due to investment losses or, in a final average pay plan, subsequent decreases in compensation.

Section 31.3121(v)(2)-1(c)(1)(ii)(A) defines an account balance plan as a nonqualified deferred compensation plan under the terms of which a principal amount (or amounts) is credited to an individual account for an employee, the income attributable to each principal amount is credited (or debited) to the individual account, and the benefits payable to the employee are based solely on the balance credited to the individual account.

Section 31.3121(v)(2)-1(c)(2)(i) provides that if benefits for an employee are provided under a nonqualified deferred compensation plan that is not an account balance plan (a nonaccount balance plan), the amount deferred for a period equals the present value of the additional future payment or payments to which the employee has obtained a legally binding right during that period.

Section 31.3121(v)(2)-1(c)(2)(ii) provides that for purposes of § 31.3121(v)(2)-1, the term present value means the value as of a specified date of an amount or series of amounts due thereafter, where each amount is multiplied by the probability that the condition or conditions on which payment of the amount is contingent will be satisfied, and is discounted according to the assumed rate of interest to reflect the time value of money. For purposes of this section, the present value must be determined as of the date the amount deferred is required to be taken into account as wages under paragraph (a) of this section using actuarial assumptions and methods that are reasonable as of that date.

Section 31.3121(v)(2)-1(e)(1) provides that except as otherwise provided in this paragraph (e), an amount deferred under a nonqualified deferred compensation plan must be taken into account as wages for FICA tax purposes as of the later of the date on which services creating the right to the amount deferred are performed (within the meaning of paragraph (e)(2) of this section) or the date on which the right to the amount deferred is no longer subject to a substantial risk of forfeiture.

Section 31.3121(v)(2)-1(e)(2) provides that for purposes of this section, services creating the right to an amount deferred under a nonqualified deferred compensation plan are considered to be performed as of the date on which, under the terms of the plan and all the facts and circumstances, the employee has performed all of the services necessary to obtain a legally binding right (as described in paragraph (b)(3)(i) of this section) to the amount deferred.

Section 31.3121(v)(2)-1(e)(3) provides that for purposes of this section, the determination of whether a substantial risk of forfeiture exists must be made in accordance with the principles of § 83 and the regulations thereunder.

Section 1.83-3(c)(1) of the Income Tax Regulations provides that for purposes of § 83 and the regulations thereunder, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture. Section 1.83-3(c)(2) provides that the regularity of the performance of services and the time spent in performing such services tend to indicate whether services required by a condition are substantial.

Section 31.3121(v)(2)-1(e)(4)(i)(A) provides that notwithstanding any other provision of this paragraph (e), an amount deferred under a nonaccount balance plan is not required to be taken into account as wages under the special timing rule of § 31.3121(v)(1)-1(a)(2) until the first date on which all of the amount deferred is reasonably ascertainable (the resolution date). In this case, the amount required to be taken into account as of the resolution date is determined in accordance with § 31.3121(v)(2)-1(c)(2).

Section 31.3121(v)(2)-1(e)(4)(i)(B) provides that for purposes of paragraph (e)(4), an amount deferred is considered reasonably ascertainable on the first date on which the amount, form, and commencement date of the benefit payments attributable to the amount deferred are known, and the only actuarial or other assumptions regarding future events or circumstances needed to determine the amount deferred are interest and mortality. For this purpose, the form and commencement date of the benefit payments attributable to the amount deferred are treated as known if the requirements of paragraph (c)(2)(iii)(B) of this section (under which payments are treated as being made in the normal form of benefit commencing at normal commencement date) are satisfied.

Section 31.3121(v)(2)-1(e)(4)(ii)(A) provides that for an amount deferred that is not reasonably ascertainable, an employer may choose to take an amount into account at any date or dates (an early inclusion date or dates) before the resolution date (but not before the date described in paragraph (e)(1) of this section with respect to the amount deferred). An employer that chooses to take an amount into account at an early inclusion date under this paragraph (e)(4)(ii) for an employee under a plan is not required until the resolution date to identify the period to which the amount taken into account relates.

Section 31.3121(v)(2)-1(e)(4)(ii)(B) provides that if an employer chooses to take a deferred amount into account as of an early inclusion date in accordance with this paragraph (e)(4)(ii) and the benefit payments attributable to the amount deferred exceed the benefit payments that are actuarially equivalent to the amount taken into account at the early inclusion date (payable in the same form and using the same commencement date as the benefit payments attributable to the amount deferred), then the present value of the difference in the benefits, determined in accordance with paragraph (c)(2) of this section, must be taken into account as of the resolution date.

Issue 1. Whether agents' rights to renewal commissions are nonqualified deferred compensation plans for purposes of § 3121(v)(2).

Each agent is covered by the Corporation X Plan for the payment of renewal commissions. This plan sets forth the renewal commissions that a retiree is entitled to receive from the insurance policies that are in force on and after the retiree's retirement date.

As a general rule, renewal commissions are considered to be remuneration for services performed in the year the sale of the insurance is consummated. Rev. Rul. 54-312, 1954-2 C.B. 327, provides that in general, commissions received by a life insurance salesman, including deferred or renewal commissions, for the sale of life insurance, annuities, or accident or health insurance are deemed to be remuneration for services performed at the time of the consummation of the sales of the contracts of insurance to which they are attributable.

The information submitted establishes that the right to the renewal commissions provided by Corporation X to its employees constitutes a nonqualified deferred compensation plan. Under the plan, it appears the agent has a legally binding right during the calendar year of the sale of the insurance policy to the renewal commissions that have not been actually or constructively received, and pursuant to the terms of the plan, the renewal commissions are payable to the employee in a later year. The employee may receive a renewal commission under the terms of the plan only if two conditions are satisfied: (1) (a) the agent is either an active sales agent of Corporation X or (b) his or her services have been terminated because of retirement, disability, or death; and (2) the insurance policy is in force on the anniversary date of the policy and the customer pays the renewal premiums. Although the employee will not receive a renewal commission if either (1) the employee is terminated for some reason other than death, retirement, or disability, or (2) the insurance is not in force, these factors eliminating the payment of the renewal commission operate by the objective terms of the plan. Although the Agent's Agreement provides that Corporation X "reserves the right to alter or modify in its discretion, with respect to business thereafter paid-for, any of the applicable Commission or Compensation Schedules . . . ," Corporation X represents that notwithstanding this language, renewal commission rates may not be reduced after the sale of the policy. Under the regulations, therefore, the compensation of an agent is not subject to unilateral reduction or elimination by Corporation X, and therefore, agents' rights to renewal commissions upon the sales of insurance policies constitute nonqualified deferred compensation plans for purposes of § 3121(v)(2).

Issue 2. Whether the renewal commissions were subject to a substantial risk of forfeiture until the customer renewed the policy and paid the renewal premiums on the policy.

Section 31.3121(v)(2)-1(c)(1)(ii) provides that an account balance plan is a nonqualified deferred compensation plan under the terms of which a principal amount (or amounts) is credited to an individual account for an employee, the income attributable to such principal amount is credited (or debited) to the individual account, and the benefits payable are based solely on the balance credited to the individual account. There is no crediting of the renewal commissions to an account when the policy is sold, there is no crediting or debiting of interest, and the benefits are not based on such a balance. Therefore, the nonqualified deferred compensation plans consisting of the agents' rights to renewal commissions are nonaccount balance plans.

Corporation X stakes its claims for refund on the position that it is eligible to take into account the renewal commissions under the early inclusion rule described in § 31.3121(v)(2)-1(e)(4)(ii)(A) set forth above which applies in the case of nonaccount balance plans. The early inclusion rule provides that the amounts may be taken into account before the resolution date, although in no event may the amounts be included in wages before "the date described in paragraph (e)(1) of this section with respect to the amount deferred." The date described in paragraph (e)(1) is the later of the date on which services creating he right to the amount deferred are performed or the date on which the right to the amount deferred is no longer subject to a substantial risk of forfeiture. Because the employees in this case have ceased to perform services for Corporation X after termination of their working relationship with Corporation X, the date of the services creating the right to the amount deferred has passed, and the remaining issue for purposes of determining the timing of the FICA taxation of the amounts deferred is the time at which the amounts deferred were no longer subject to a substantial risk of forfeiture.

Section 31.3121(v)(2)-1(e)(3) of the regulations provides that the determination of whether a substantial risk of forfeiture exists for purposes of § 3121(v)(2) and the FICA taxation of nonqualified deferred compensation is made in accordance with the principles of § 83 and the § 83 regulations. Section 1.83(c)-3(c)(1) provides that whether a risk of forfeiture is substantial depends upon all the facts and circumstances. Moreover, it further provides that a substantial risk of forfeiture can exist in either of two possible circumstances. A substantial risk of forfeiture can exist where rights in property are conditioned upon the future performance (or refraining from performance) of substantial services by any person. In this case, upon the retirement of the agent, the agent has performed all the services that he or she will perform in connection with the life insurance policies to which the renewal commissions relate. Thus the rights of the retired agent to the renewal commissions are not conditioned upon the future performance of services by the retired agent. In addition, the legal rights of the retired agent to renewal commissions do not appear to be affected by the services performed by the agent to whom the policy is transferred upon the agent's retirement, and, in any event, the additional services that are necessary to service the policy are insubstantial.

Under § 1.83-3(c)(1), a substantial risk of forfeiture can also exist if the rights to the property are conditioned, directly or indirectly, upon the occurrence of a condition related to the purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. That part of the definition of substantial risk of forfeiture is relevant to the specific facts present in this case.

Each renewal commission is conditioned on the continued existence in force (or renewal) of the underlying insurance policy on the date the renewal commission is scheduled to be credited to the agent (the policy anniversary date) and the payment of the related renewal premiums. There are a number of reasons why a policy may not be renewed. For example, the policy holder may lose the financial ability to pay; the policyholder may decide that changed financial or personal circumstances make termination of the policy appropriate; or the policyholder may decide to buy other insurance from another company or may have a new employer that provides insurance. If the policy is not renewed through payment of the related renewal premium, the agent loses the renewal commission he would otherwise have received on that policy.

This condition for the payment of the renewal premium is related to the purpose of the transfer of the renewal commissions to the agent, which is to provide an incentive for the agent to sell insurance policies that customers will renew. Because insurance policies are generally profitable to Corporation X only if they continue in force for a number of years, Corporation X has a vital interest in providing agents with incentives for the sale of policies that are more likely to be renewed and thus become profitable. In your request for assistance, you provided documentation indicating that Corporation X specifically recognizes the importance of agents in increasing the persistency rate. The renewal commissions provide an incentive for agents to sell insurance that meets the needs of the policyholder and to sell to more financially stable purchasers. Such insurance is more likely to be renewed and to increase the profitability of Corporation X.

Two examples in the § 83 regulations illustrate circumstances where there is a substantial risk of forfeiture in circumstances analogous to this case. Section 1.83-2(c)(2) provides that when stock is transferred to an underwriter prior to a public offering and the full enjoyment of such stock is expressly or impliedly conditioned upon the successful completion of the underwriting, the stock is subject to a substantial risk of forfeiture. This example is analogous to the facts and circumstances in this case in that just as the transferred stock is intended to reward the underwriter only if the offering occurs, so too Corporation X intends that the agent be rewarded through payment of a renewal commission only if the customer renews the insurance policy and pays the renewal premium.

The current factual situation is also analogous to Example (2) of § 1.83-3(c)(4) of the § 83 regulations. In this example, an employer funded an educational trust for its employees. The payment of annual grants from the trust to the employee's child on behalf of the employee was conditioned on the employee's child completing an academic year as a student in good standing at an accredited educational institution as a degree candidate. If the student does not complete the year in good academic standing, the cash grant is forfeited. The example concludes that the benefit to the employee is subject to a substantial risk of forfeiture to the extent the employee's child has not met the condition to become entitled to a grant.

In this case, if the policy is not renewed with the renewal premium paid, the renewal commission is forfeited. As we understand from what you have submitted to us, the taxpayer maintains that based on company-wide persistency rates for life insurance policies, the value of the renewal commissions that an agent will receive, when all the policies are aggregated, is generally predictable. Therefore, the argument concludes, the commissions are not subject to a substantial risk of forfeiture, allowing the taxpayer to apply § 31.3121(v)(2)-2(e)(4)(ii)(A) to include the value of the aggregate projected renewal commissions at the time the agent retires rather than waiting until each policy is renewed, and each commission is actually paid. Under the policies as we understand them, the legal right to deferred compensation accrues with respect to each individual policy. Each commission has a separate date on which the conditions related to the purpose of the transfer of the renewal commissions will have been satisfied. Because any amount deferred under the nonqualified deferred compensation plan has its genesis in the sale of a particular insurance policy, the substantial risk of forfeiture of the rights to that amount deferred is determined with respect to the renewal of that particular policy rather than whether the agent may be entitled to other deferred amounts arising from other insurance policies. Although an actuary may be able to estimate a present value for an agent's right to the bundle of renewal commissions he or she is eligible to receive at retirement, the regulations look to when the condition that relates to the purpose of the transfer – in this case the transfer of the right to the renewal commission on the policy – is satisfied, and to whether the risk of forfeiture is substantial. The determination of when the condition is satisfied must be made separately for each policy.

As we understand from your submission and the taxpayer's response to an information document request, the taxpayer cites Examples 14 and 17 under § 31.3121(v)(2)-1(e)(7) of the regulations as support for its position that the risk that each policy will not be renewed merely affects the value of the amount deferred and does not constitute a substantial risk of forfeiture. Examples 14 and 17 are primarily intended to illustrate principles other than whether there existed a substantial risk of forfeiture in certain conditional transfers, and thus do not provide the best guidance on determining whether there exists a substantial risk of forfeiture under § 83 principles. Example 14 illustrates the timing of inclusion in wages for FICA purposes for an amount of deferred compensation that is not initially reasonably ascertainable, and Example 17 illustrates how amounts of deferred compensation may be allocated to deferral years. Examples 14 and 17 make implicit assumptions that no substantial risk of forfeiture exists, but do not provide sufficient facts to explain why no substantial risk of forfeiture exists.

Unlike the facts of the examples in the § 83 regulations, which are intended to illustrate when a substantial risk of forfeiture exists, the facts of Examples 14 and 17 do not align with the facts of this case. In the case of these renewal commissions, the condition related to the purpose of the transfer (renewal of the policy) is very closely tied to the purpose of the transfer, whereas the connection between the condition (profitability) and the purpose of the transfer is unclear in Examples 14 and 17. As noted above, the Company has also indicated that there is a close correlation between the condition and the individual employee's efforts. The Company depends on the agent's judgment and initiative to sell policies to policyholders who are likely to renew. In Examples 14 and 17, the degree to which there is a connection between the condition (profitability) and the efforts of the employee is unclear based on the facts presented in the examples. The purpose of the transfer could be to provide compensation from profits that will not be available until some point in the future for services that may or may not correlate strongly to the existence of profits. By comparison, the examples in the § 83 regulations illustrate circumstances where there is an apparent correlation between the forfeiture condition and the purpose of the transfer.

Based on the information furnished we conclude that the retired agents' rights to the renewal commissions constitute nonqualified deferred compensation plans. Under the specific facts and circumstances here and taking into consideration the examples under both the § 83 regulations and the § 3121(v) regulations, we further conclude that the agent's right to each renewal commission is subject to a substantial risk of forfeiture until the underlying policy is renewed and the renewal premium is paid, which is approximately when the renewal commissions are paid to the retired agent.

<u>Issue 3. Whether the IRS should approve Corporation X's refund claims for FICA taxes paid with respect to renewal commissions paid to retired agents</u>.

Following from the analysis of Issues 1 and 2, the IRS should deny in full Corporation X's claims for refund of FICA taxes.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>

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This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call if you have any further questions.