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subject: Deductibility under § 404 of contribution paid to a qualified retirement plan under the objective outlay-of-assets test of Don E. Williams Co. v. Commissioner, 429 U.S. 569 (1977)

This memorandum provides general legal advice on the determination of whether a contribution by an employer to the employer's qualified retirement plan has actually been paid to the plan's trust such that the contribution is deductible under § 404(a) of the Internal Revenue Code ("Code") for the employer's taxable year in which the contribution is made (assuming all other applicable requirements are satisfied). This determination is made under the standards set forth in Don E. Williams Co. v. Commissioner, 429 U.S. 569 (1977), which applies an objective outlay-of-assets test. This memorandum describes the elements of this test, provides that the application of the test is made taking into account the relevant facts and circumstances of the contribution, and includes illustrative examples.[1]

This memorandum should not be used or cited as precedent.

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[1] The analysis in this memorandum is limited to the determination of whether a contribution is deductible under § 404(a). This memorandum does not address the treatment or characterization of similar transactions under other provisions of the Code or the Employee Retirement Income Security Act of 1974 (Pub. L. No. 93-406 (88 Stat. 829)), as amended (ERISA). Moreover, the analysis does not depend on the classification (for example, as stock or indebtedness) of the asset contributed, or whether the contribution is subject to or exempt from the prohibited transaction rules of section 406 or 407 of ERISA and § 4975 of the Code.

ISSUE

For purposes of § 404(a), how is a determination made that an employer's contribution has been paid within the meaning of § 404(a) to the trust of a qualified retirement plan in a taxable year of the employer maintaining the plan for which the employer claims a deduction?

CONCLUSION

For a contribution by an employer to the trust of a qualified retirement plan maintained by the employer to be deductible under § 404(a) for the employer's taxable year in which the contribution is made, the contribution must be a payment of cash (or its equivalent) or property to the trust.

Whether a contribution is paid for purposes of § 404(a) is determined under the objective outlay-of-assets test set forth in Don E. Williams. The employer must experience an outlay of, or reduction in, its assets when the contribution is made. Moreover, the trust must receive the full advantage of the contribution (and thus there must be no retention by the employer of significant control over the contributed asset or imposition of a significant encumbrance on the trustee's ability to dispose of the asset). Whether these elements are satisfied depends on the facts and circumstances of the particular contribution.

LAW AND ANALYSIS

Under § 404(a), the determination of whether a contribution by an employer to the employer's qualified retirement plan is deductible for the employer's taxable year in which the contribution is made depends in part on whether the contribution constitutes a payment of cash (or its equivalent) or property to the plan's trust. The resolution of this issue depends, in turn, on whether the contribution satisfies the objective outlay-of-assets test set forth in Don E. Williams, as described below.

1. Section 404(a)

Section 404(a) governs the deductibility of a contribution to the trust of a deferred compensation plan maintained by an employer for its employees that satisfies the qualification requirements of § 401(a). Pursuant to § 404(a)(6), if an employer makes a payment no later than the due date (including extensions) for filing the employer's return for a taxable year, and if the payment is on account of that taxable year, then the employer is deemed to have made a payment on the last day of the preceding taxable year.

Among other requirements, in order for an employer to deduct a contribution under § 404(a), the amount must be paid by the employer to the qualified trust. The words "paid" and "payment" appear throughout § 404(a) ("payment requirement").[2] Congress has also repeatedly emphasized the importance of the payment requirement.[3] In H.R. Rep. No. 77-2333 (1942), the Ways and Means Committee stated: "The present law endeavors to encourage the setting up of retirement benefits by employers for their employees and in pursuance of this policy permits employers to take as a deduction amounts irrevocably set aside in a pension trust or other fund to provide annuities or retirement benefits for superannuated employees." See H.R. Rep. No. 77-2333, at 50.

Finally, the regulations under § 404(a), promulgated in 1956, also emphasize the importance that the contribution actually be paid. See Treas. Reg. §1.404(a)-1(c) (contribution "is paid"… "payment is actually made."); Treas. Reg. §1.404(a)-3(a) ("contributions are paid"… "contributions must be paid in a taxable year."). As the Supreme Court has noted, these regulations under § 404 should be accorded significant weight.[4]

2. Don E. Williams and the Objective Outlay-of-Assets Test

As noted above, the use of the terms "paid" or "payment" imposes the requirement of actual payment, rather than simply the recognition (accrual) of a liability to make payment. Although neither the Code nor the regulations thereunder set forth a standard for determining what constitutes payment under § 404(a), the Supreme Court, in Don E. Williams, applied an objective outlay-of-assets test to determine if an employer had made a payment to a qualified trust for purposes of claiming a deduction under § 404(a). Don E. Williams, 429 U.S. at 579. The employer in that case argued that the contribution of a fully secured promissory demand note to the trustee of a profit sharing plan and trust constituted an "amount paid" within the meaning of § 404(a)(1). Id. at 570. The Court disagreed, stating that "the note, for the maker, even though fully

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[2] For example, the word "paid" appears twice in the lead-in language of § 404(a). See also paragraphs (a)(1)(A) ("In the taxable year when paid, if the contributions are paid…"); (a)(1)(E) ("Any amount paid in a taxable year in excess of the amount deductible in such year …"); and (a)(6) ("For purposes of paragraphs (1), (2), and (3), a taxpayer shall be deemed to have made a payment on the last day of the preceding taxable year if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).").

[3] See H.R. Rep. No. 77-2333 (1942), at 106 ("compensation is paid"); S. Rep. No. 77-1631, at 141 (1942) ("compensation is paid"); H.R. Rep. No. 80-2087, at 13 (1948) ("contributions actually paid"); H.R. Rep. No. 83-1337 (1954), at 43 ("payments to a" qualified trust or plan) and A151 (payment "is made"); S. Rep. No. 83-1622, at 55 (1954) ("actual payments"); Staff of J. Comm. on Taxation, 83rd Cong., Summary of the New Provisions of the Internal Revenue Code of 1954, at 62 ("actually made a payment").

[4] See Don E. Williams v. Commissioner, 429 U.S. at 576-77 ("The applicable Treasury Regulations since 1942 consistently have stressed payment by the accrual-basis taxpayer. See Reg. 111, s 29.23(p)-1 (1943); Reg. 118, § 39.23(p)-1(d) (1953); Reg. § 1.404(a)-1(c), 26 CFR § 1.404(a)-1(c) (1975). With the statute re-enacted in the 1954 Code, this administrative construction may be said to have received congressional approval. See Lykes v. United States, 343 U.S. 118, 127 (1952).").

secured, is still only his promise to pay [and] [i]t does not in itself constitute an outlay of cash or other property."[5] Id. at 579.

Relying in part on earlier decisions,[6] the Court analyzed the payment requirement of § 404(a):

> The statutory terms "paid" and "payment," coupled with the [§ 404(a)(6)] grace period and the legislative history's reference to "paid" and "actually paid," demonstrate that, regardless of the method of accounting, all taxpayers must pay out cash or its equivalent by the end of the grace period in order to qualify for the § 404(a) deduction. This accords, also, with the apparent policy behind the statutory provision, namely, that an objective outlay-of-assets test would insure the integrity of the employees' plan and insure the full advantage of any contribution which entitles the employer to a tax benefit."

Id. at 578-79 (footnote omitted).

Justice Stevens, in his concurring opinion, explicitly tied the payment requirement to the purpose behind § 404(a):

> Mr. Justice Blackmun's opinion for the Court, which I join, construes the word "paid" to require the delivery of cash or its equivalent. In my judgment, that construction best serves the statutory purpose of protecting the integrity of pension plans because the employer and the pension trust are often controlled by the same interests.

Id. at 583 (Stevens, J., concurring).

The Court distinguished a promissory note from a bank check:

> The line between [a promissory note and a check] may be thin at times, but it is distinct. The promissory note, even when payable on demand and fully secured, is still, as its name implies, only a promise to pay, and does not represent the paying out or reduction of assets. A check, on the other hand, is a direction to the bank for immediate payment, is a medium of exchange, and has come to be treated for federal tax purposes as a conditional payment of cash. Estate of Spiegel v. Commissioner, 12 T.C. 524 (1949); Rev. Rul. 54-465, 1954-2 Cum. Bull. 93. The factual difference is illustrated and revealed by taxpayer's own payment of each promissory note with a check within a year after issuance.

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[5] The promissory note at issue in Don E. Williams was the employer's own, acknowledging its obligation to the trust.

[6] The Court cited Eckert v. Burnet, 283 U.S. 140 (1931) (denying a deduction for a taxpayer's exchange of a note because the transaction involved no "outlay of cash or property having a cash value"), and Helvering v. Price, 309 U.S. 409 (1940) (giving a personal note did not give rise to a deduction because the personal note "was not the equivalent of cash"). Don E. Williams, 429 U.S. at 578.

Don E. Williams, 429 U.S. at 582-83.[7]

The Court also found that, for purposes of determining satisfaction of the payment requirement, it is irrelevant whether the employer's promissory note is secured, because the provision of collateral is not payment and does not transform the promise into an actual payment within the meaning of § 404(a).[8]

Accordingly, because the employer in Don E. Williams parted with none of its assets upon the issuance of its promissory note, the Court held that it was not entitled to a deduction under a statute that requires the actual payment of a contribution.

Subsequently, the Tax Court applied the objective outlay-of-assets test to determine whether an employer is entitled to a current deduction for a contribution of property to a qualified trust that was agreed to but not completed before the end of the grace period. In Reed Smith Shaw & McClay v. Commissioner, T.C.M.1998-64 (1998), the Tax Court considered whether a taxpayer was entitled to deduct a contribution made for a taxable year when the taxpayer and the retirement plan trustee entered into an agreement to contribute shares of stock before the end of the grace period described in § 404(a)(6) but the taxpayer failed to transfer title and control of the shares to the qualified trust until after the end of the grace period. The court applied the objective outlay-of-assets test in upholding the IRS' determination that no deduction under § 404(a) was allowed for the taxable year with respect to the contribution and cited other cases in which, in the court's view, the objective outlay-of-assets test was applied.[9] The court in Reed Smith emphasized that "[a]n employer must irrevocably set aside the contribution for the plan

[7] Prior to Don E. Williams, the Court and the Internal Revenue Service (IRS) articulated the rule that delivery of a taxpayer's own promissory note to a retirement plan trust does not constitute payment that entitles the taxpayer to an immediate deduction. See, e.g., Logan Eng'g Co. v. Commissioner, 12 T.C. 860 (1949) ("an actual payment of the contribution to an employees' trust in the taxable year is a prerequisite to the allowance of a deduction on account thereof, and… the issuance and delivery of a promissory note does not constitute such actual payment"); Rev. Rul. 71-95, 1971-1 C.B. 130 (the delivery of a taxpayer's own term promissory note to an employees' trust does not constitute payment for purposes of § 404(a)).

[8] Don E. Williams, 429 U.S. at 578 (citing Helvering v. Price, 309 U.S. 409 (1940)) ("There the taxpayer argued that his giving a secured note to a bank in response to a guarantee gave rise to a deduction. The Court observed that the note "was not the equivalent of cash to entitle the taxpayer to the deduction," and concluded that the fact the note was secured made no difference in the result. "[T]he collateral was not payment. It was given to secure respondent's promise to pay" and "did not transform the promise into the payment required to constitute a deductible loss in the taxable year." Id., at 413-414. The reasoning is apparent: the note may never be paid, and if it is not paid, "the taxpayer has parted with nothing more than his promise to pay." Hart v. Commissioner, 54 F.2d 848, 852 (CA1 1932).").

[9] "For example, we have held that an employer's accrual on its books of its liability for a plan contribution does not constitute "payment" of the contribution for purposes of § 404(a). See Gillis v. Commissioner, 63 T.C. 11 (1974). Similarly, we have held that there was no "payment" under § 404(a) when an employer merely designated on its books and on the books of the plan that a portion of a certificate of deposit belonged to the plan. See Rollar Homes, Inc. v. Commissioner, T.C.M. 1987–166." Reed Smith, T.C.M.1998-64 at 6.

or remove the contribution from the employer's direct control" in order to qualify for a deduction under § 404(a). Id. at 6.

The objective outlay-of-assets test includes a requirement that, as a result of the contribution for which it claims a deduction under § 404(a), an employer must experience an outlay of, or reduction in, its assets and the trust must receive the full advantage of the contribution. A promise to pay, even if secured and certificated, is not payment for purposes of § 404(a) if there is no outlay of cash or property by the employer. See Don E. Williams, 429 U.S. at 582-83 ("[The] promissory note, even when payable on demand and fully secured, is still, as its name implies, only a promise to pay, and does not represent the paying out or reduction of assets."); Reed Smith, T.C.M. 1998-64 at 6 ("An employer must irrevocably set aside the contribution for the plan…"); Gillis, 63 T.C. at 18 ("The statutory scheme, it seems clear enough, requires that an accrual basis taxpayer part with something of value to the pension plan trustee. Petitioner did not part with anything during the required time. It only accrued an obligation on its books. And that is not enough.").

In addition, Don E. Williams and later decisions highlight the relevance of control over the asset following its contribution as a factor in determining whether a contribution satisfies the objective outlay-of-assets test. Thus, the degree of control or influence retained by an employer over the contribution is an important element of the objective outlay-of-assets test, as is the degree of encumbrance on the asset restricting the trustee's flexibility to use it to best fit the needs of the plan. These elements of the objective outlay-of-assets test apply in order to determine whether the trust has received the full advantage of the contribution at the time the contribution is made. An employer who retains significant control over the contributed asset has not actually made a payment to the trust, because no amount is "irrevocably set aside" for the plan. See Reed Smith, T.C.M. 1998-64 at 6; H.R. Rep. No. 77-2333 at 50. See also Rollar Homes, Inc. v. Commissioner, T.C.M. 1987-166 (1987) ("Consequently, even though the beneficiaries of the plan may have acquired some equitable rights to a portion of the CD, such acquisition did not irrevocably set aside the contribution for the plan or remove the contribution from the direct control of petitioner.").

Similarly, the degree of encumbrance on the contributed asset is evidence of the extent to which the trustee has the ability to use the asset in a way that best meets the plan's needs, taking into account the nature of the asset. A trustee's ability to liquidate a trust asset is necessary for a qualified trust to be able to pay benefits; for example, if contributed property cannot be sold on account of restrictions placed by the employer, then the trust may not have the liquidity necessary to pay participant benefits in a timely manner. This danger is avoided if the contributed property is not significantly encumbered. As the Supreme Court has noted, "the apparent policy behind the statutory provision [is to] insure the integrity of the employees' plan and insure the full advantage of any contribution which entitles the employer to a tax benefit." Don E. Williams, 429 U.S. at 579.

Accordingly, for a contribution by an employer to the trust of a qualified retirement plan maintained by the employer to be deductible under § 404(a) for the employer's taxable year in which the contribution is made, the contribution must be a payment of cash (or its equivalent) or property to the trust. For a contribution to the trust to be a payment under § 404(a), the contribution must satisfy the objective outlay-of-assets test of Don E. Williams as described above, which requires: (1) an outlay of, or reduction in, the employer's assets, and (2) that the trust is entitled to the full advantage of the contribution (and thus there is no retention of significant control over the contributed asset by the employer or imposition of a significant encumbrance). Taken together, these elements support the application of the objective outlay-of-assets test in accordance with its purposes as articulated by the Supreme Court in Don E. Williams, thus ensuring the integrity of the qualified trust and the full advantage to the trust of any contribution that entitles the employer to a tax benefit. Don E. Williams, 429 U.S. at 579.

3. Facts and circumstances to be taken into account in applying the objective outlay-of-assets test

Some employers that maintain qualified retirement plans for the benefit of their employees have claimed a deduction under § 404(a) for the employer's taxable year for the contribution to a plan of a note obligating the employer to pay cash or property to the trust after the end of the grace period described in § 404(a)(6) for that taxable year, with no current outlay or reduction in the employer's assets. In other cases, an employer has retained significant control over an asset following its contribution in the taxable year for which the deduction under § 404(a) is claimed, or the asset is so encumbered that the trustee cannot effectively utilize the asset to pay plan benefits.

Whether a contribution has actually been paid to a qualified trust under the two elements of the objective outlay-of-assets test of Don E. Williams, as described in this memorandum, depends on the facts and circumstances of the contribution. The following illustrate the first element, whether there has been an outlay of, or reduction in, the employer's assets:

> Employer's promissory note. An employer contributes its own promissory note to the plan obligating the employer to pay cash (or its equivalent) or property to the trust at a later date. The contribution is not deductible as an actual payment under § 404(a) regardless of whether the note is secured or transferable, because the note's contribution is not an outlay of, or reduction in, the employer's assets.[10]

[10] In contrast to the contribution of an employer's promissory note to the trust, the transfer of an unrelated third-party's promissory note held by the employer to a plan's trust may be the payment of a contribution for purposes of § 404(a) (assuming the employer does not retain significant control over the note nor is the trustee's use of the note significantly encumbered), so that the employer may deduct the fair market value of the contribution of the unrelated-third-party note for a taxable year if it is made within the applicable grace period (subject to the limitations of § 404(a)).

Employer debt. An employer contributes its own publicly traded debt to the plan. The contribution of the debt instrument is essentially the same as the contribution of a promissory note because the debt instrument reflects the employer's promise to make payments to the instrument's owner at a later date and thus is not an outlay of, or reduction in, the employer's assets. Similarly, the contribution by the employer of debt of a member of its controlled group (within the meaning of § 414(b), (c) or (m)) is not an outlay of, or reduction in, the employer's assets.

Book entry. An employer's designation of its liability for a plan contribution as a debit on its books and an accrual on the books of the plan, without a corresponding transfer of assets to the plan, is not an actual payment of the contribution, because the book entry, by itself, is not an outlay of, or reduction in, the employer's assets.

Treatment of contributed asset as an asset of the employer for accounting purposes. An employer's continued treatment for purposes of its financial statements of an asset contributed to the qualified trust as an asset of the employer, or its inability otherwise to treat the asset solely as an asset of the plan, is a factor to be taken into account in determining whether there is an outlay of, or reduction in, the employer's assets.

The following illustrate the second element of the objective outlay-of-assets test, whether the trust has received the full advantage of the contribution (and thus there is no retention of significant control over the contributed asset by the employer or imposition of a significant encumbrance):

Asset inaccessible. A trustee's inability to access a contributed asset (including an asset that is cash or otherwise unencumbered) indicates the trust has not received the full advantage of the contribution, because the trustee's use of the asset is significantly encumbered for as long as the asset continues to be inaccessible following its contribution. The asset may be inaccessible, for example, if the cash or property is placed in escrow; the asset is available first to other creditors of the employer; or the property is not transferrable for a number of years or without the prior approval of the employer.

Employer option to repurchase property (call option). A contribution of property (such as shares of employer stock, whether or not publicly traded) that includes an employer option to repurchase the property at the employer's discretion, or for a set number of years following the contribution, is a factor to be taken into account in determining whether the employer has retained significant control over the asset, even if the repurchase price is to be determined by an independent fiduciary or is set to be equal to or exceed the asset's fair market value.

Option to require employer to repurchase contributed property (put option). A contribution of property (such as shares of employer stock, whether or not publicly traded) subject to a put option requiring the employer to repurchase the

contributed property is a factor to be taken into account in determining whether the trust has received the full advantage of the contribution (for example, if the asset is significantly encumbered because the trustee cannot exercise the put option without the employer's consent or for a set number of years following the contribution). This may be true even if the asset subject to the put option is to be sold at a price equal to or exceeding its fair market value. Similarly, a put option that includes a right for the employer to delay the settlement date for a significant period of time is a factor to be taken into account in determining whether the trust has received the full advantage of the contribution on account of the employer's retaining significant control over the asset.

Other restrictions on trustee's ability to transfer the asset. Other restrictions on the trustee's ability to transfer or optimize the use of the contributed asset are also factors to be taken into account in determining whether the trust has received the full advantage of the contribution (because the employer has retained significant control over the asset or the trustee's use of the asset is significantly encumbered). Examples of other restrictions include a prohibition on the trustee's transferring the contributed asset to a third party or the trustee's pledging the asset as security for a loan.

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