OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Chief, Branch 7 (EBEO)
CC:EBEO:7

SUBJECT:

This Field Service Advice responds to your memorandum dated September 15, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

ISSUE: Whether the Service should pursue the theory that the "if they would otherwise be deductible [under this Chapter]" language of IRC § 404(a) means that both cash and accrual basis taxpayers must satisfy the all-events and economic performance tests of IRC § 461 in order for qualified plan contributions to be deductible under IRC § 404.

CONCLUSION: The Service should not pursue the theory that the "if they would otherwise be deductible [under this Chapter]" language of IRC § 404(a) means that both cash and accrual basis taxpayers must satisfy the all-events and economic performance tests of IRC § 461 in order for qualified plan contributions to be deductible under IRC § 404.

LAW AND ANALYSIS:

Prior to the Tax Reform Act of 1986 ("TRA"86"), Pub. L. No.99-514, IRC § 404(a) provided as follows:

> **(a) General rule.** -- If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

Section1851(b)(2)(C)(i) of TRA'86 amended IRC § 404(a) to substitute "this Chapter" for "section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income)", and "if they would otherwise be deductible" for "if they satisfy the conditions of either of such sections." Accordingly, IRC § 404(a) now provides as follows:

> **(a) General rule.**--If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under this chapter; but, if they would otherwise be deductible, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

The legislative history explains that the change was intended "to clarify that the deduction-timing rules for [nonqualified] deferred compensation arrangements apply to any plan or method of deferring compensation regardless of the section under which the amounts might otherwise be deductible and that the amounts shall be deductible under section 404(a)(5) and shall not otherwise be deductible under any other section." The clarification was necessary "to prevent taxpayers from asserting that deferred compensation is attributable to capitalizable compensation expenses and, thereby, accelerate the timing of the deduction for such deferred compensation." S. Rep. No. 313, 99th Cong., 2nd Sess. 1013 (1986).

IRC §461 provides that the amount of any deduction or credit is taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income. IRC §461(h) and Treas. Reg. §1.461-1(a)(2)(i) provide that, under the accrual method of accounting, a liability is incurred, and is generally taken into account for federal income tax purposes, in the taxable year in which (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability. Treas. Reg. §1.461-

4(d)(2)(iii) also provides, in part, that, "[e]xcept as otherwise provided in any Internal Revenue regulation, revenue procedure, or revenue ruling, the economic performance requirement is satisfied to the extent that any amount is otherwise deductible under section 404...." (Treas. Reg. §1.461-4(d)(2)(iii) was effective April 10, 1992). In addition, the economic performance rules never apply to cash method taxpayers.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Based on the legislative history cited above, we do not believe that the TRA'86 change in the specific language of IRC § 404(a) affects the meaning of IRC § 404(a). IRC § 404(a), prior to its amendment by TRA'86, specifically referenced IRC §§162 and 212 and required that contributions otherwise satisfy the requirements applicable to deductions under those sections; namely, that the contributions must be ordinary, necessary and reasonable business expenses. How the IRC §461 accounting rules may apply to qualified plan contributions is not well-established.[1]

Prior to ERISA, several cases held that in order for contributions made after the close of an employer's taxable year to be deductible under IRC § 404(a)(6), the employer must establish that it had a liability to make that contribution by the close of its taxable year. (IRC § 404(a)(6) provides that a deductible contribution must be "on account of" a taxable year.) See Misceramic Tile, Inc. v. Commissioner, T.C. Memo. 1968-31 (employer contributions to defined benefit plan held deductible under IRC § 404(a)(6) because plan document and board of director resolution created a "liability"); Subscription Television, Inc. et al v. Commissioner, 532 F.2d 1021 (5th Cir. 1976)(court denied deduction for employer contributions to profit sharing plan under IRC § 404(a)(6) because "fact of liability" requirement was not satisfied when board of directors did not take action by end of employer's taxable year). See also Raybestos Manhattan, Inc. v. U.S., 597 F.2d 1379 (Ct.Cl. 1979) and cases cited therein (court held that the "on account of" requirement of IRC § 404(a)(6) requires taxpayer to establish some link between contribution and year for which contribution deduction is claimed). However, to our knowledge, no case has addressed whether a similar requirement would apply if the contribution had been made prior to the close of the employer's taxable year under IRC § 404(a). See Plastic Engineering & Manufacturing Co., v. Commissioner, 78 T.C. 1187, fn.5 (1982) (court noted: "Respondent, apparently because the statute allows the deduction "when paid," does not argue that accrual accounting principles or any of the cases dealing with prepaid expenses have any application.")

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[1] However, it is well-established that the economic performance rules never apply to cash method taxpayers. See IRC § 461(a).

In addition, no clear and explicit guidance has been issued by the Service on this issue. Rev. Rul. 71-38, 1971-1 C.B. 130, which provided that a deduction under IRC § 404(a)(6) required an employer to establish a "fact of liability" prior to the close of its taxable year, was later declared obsolete under Revenue Ruling 84-50, 1984-1 C.B. 279. But see Rev. Rul. 74-468,1974-2 C.B.140, which was not addressed in Rev. Rul. 84-50 (employer liability for contributions to a qualified profit sharing plan is established by the plan's terms, to the extent they exist; any contributions in excess of those stipulated by the plan require that additional action be taken by the employer to establish its liability for the contribution and to notify participants). In addition, under Treas. Reg. §1.404(a)-1(c), a contribution made after the close of an employer's taxable year, which under IRC § 404(a)(6) must be made "on account of" the employer's preceding taxable year, must be "accruable under section 461" in order to be deductible. However, the regulations do not address the applicability of IRC §461 to contributions made under IRC § 404(a).

Accordingly, because the case law and published guidance on this issue are unclear, we believe that, absent additional guidance, there would be substantial litigation hazards to overcome before we could successfully argue the issue. Therefore, we do not recommend pursuing the theory that the "if they would otherwise be deductible [under this Chapter]" language of IRC § 404(a) means that both cash and accrual basis taxpayers must satisfy the all-events and economic performance tests of IRC § 461 in order for qualified plan contributions to be deductible under IRC § 404.

However, while we do not recommend pursuing the theory discussed above, we continue to believe that contributions made after the close of an employer's taxable year and prior to the due date of the employer's tax return must be made "on account" of such taxable year under IRC § 404(a)(6). This position is supported by recent decisions of the Tax Court and the Ninth Circuit in Lucky Stores, Inc. v. Commissioner, 107 T.C. 1 (1996), aff'd, 98-2 U.S.T.C. Para. 50,662 (9th Cir. August 20, 1998) and Airborne Freight Corporation v. United States, 96-1 U.S.T.C. Para. 50,004 (W.D. Wash. 1995), rev'd, 98-2 U.S.T.C. Para. 50,664 (9th Cir. August 20, 1998), in which the courts held that the "plain meaning" of IRC §404(a)(6) precludes an employer from deducting, for its current taxable year, payments that were attributable to compensation earned by plan participants after the end of that taxable year. The courts noted that "the procedures that employers and administrators use to determine contribution amounts" (e.g., determined by the hours or weeks of employee service rendered during the immediately preceding month) clearly indicate that such contributions are not made "on account of" the employer's current taxable year as required by IRC §404(a)(6). Although Lucky Stores and Airborne Freight involved collectively-bargained multiemployer defined benefit plans, the reasoning of these cases is equally applicable to IRC §401(k) plan contributions because, in both collectively-bargained multiemployer defined benefit plans and IRC §401(k) plans, the contributions made by an employer relate to specific work performed by the employee for a particular period of time (e.g., month). These situations are distinguishable from situations involving contributions made to single employer defined benefit plans because contributions to such plans are not related to specific work performed for a particular period of time but, rather, they are based, in general, on an actuarial calculation of the minimum amount that must be paid for the valuation year in order to fund the benefits under the plan in accordance with an acceptable actuarial cost method, as required by IRC §412, and the maximum amount that may be paid and deducted by the employer under IRC §404.

If you have any further questions, please call 202-622-6090.

Chief, Branch 7 (EBEO)

By: ______________________________

MICHAEL ROACH
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