May 24, 1999

Index Nos.: 83.12-00; 404.10-00;
419.03-00; 461.01-00

Control No.: CC:EBEO:4/TAM-108992-98
Number: **199934002**
Release Date: 8/27/1999

INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Ident. No.:

Taxable Years at Issue:

Date of Conference:

Legend:

Taxpayer =

Plan =

Trust Agreement =

ISSUES:

(1) Whether, under the rules of section 461 of the Internal Revenue Code, Taxpayer's vacation pay was properly accrued for its vacation plans that included a "use-or-lose" provision and for its employees whose employment could be terminated for cause.

(2) Whether Taxpayer's purchases of letters of credit to secure its promises

to pay employee benefits had a sufficient nontax business purpose and sufficient economic substance to cause them to be respected for federal tax purposes.

CONCLUSIONS:

(1) A use-or-lose provision is a condition subsequent that does not delay the accrual of a liability. A vacation pay liability is fixed and accruable as the employee performs services for the employer. If an employee's vacation pay is subject to a length-of-service threshold, the vacation pay liability is fixed and accruable once the employee serves the required minimum length of service. Termination for cause is also a condition subsequent. Thus, the possibility that an employee might have been terminated for cause did not delay Taxpayer's accrual of vacation pay for the year in which it was earned by the employee's performance of services.

(2) Taxpayer's purchases of letters of credit to secure its promises to pay employee benefits lacked a sufficient nontax business purpose and sufficient economic substance to cause them to be respected for federal tax purposes. This means that we have also concluded that, by purchasing the letters of credit, Taxpayer made no "transfers of property" under the rules of section 83 of the Code. Thus, Taxpayer was not entitled to compensation expense deductions for the subject benefits for its taxable years during which those benefits were earned because the deductions were governed by either section 404 or section 419, both of which delay the deductions until a later year.

FACTS[1]:

For the taxable years at issue, Taxpayer and its subsidiary corporations ("Taxpayer-Group") used the accrual method of accounting, had a 52-53 week taxable year ending on the Saturday closest to January 31st, and filed consolidated returns. During those years, Taxpayer-Group maintained vacation plans and sick-pay plans for its employees. Short-term disability benefits were also paid under the sick-pay plans.

The terms of the vacation plans varied somewhat, depending on the particular member of Taxpayer-Group, its location, and applicable union contracts. Generally, employees were required to be employed for a minimum period (typically, one year) before they would become entitled to a vacation with pay. Employees who were employed for the specified period were paid for their earned vacation upon voluntary

---

[1] Taxpayer and the examining officer disagree on the facts of this case. In such instances, the National Office may refuse to provide technical advice or may provide advice based on the facts provided by the examining officer. See sections 10.03 and 10.04 of Revenue Procedure 99-2, 1999-1 I.R.B. 73, 86. In this instance, we have decided to provide technical advice.

termination of employment and upon involuntary termination other than for cause.

Vacations were based on the employee's hire date. Unless otherwise required by State law, new full-time and salaried employees earned their first vacation upon reaching the anniversary of their hire date. Employees who completed six months of continuous service in the first calendar year of employment could take one week of vacation after six months but had to repay those vacation benefits if they separated from employment before reaching their first anniversary date. Employees who completed their first anniversary year could take all succeeding vacations as of January 1, based upon their length of service to be completed during the calendar year. Vacation benefits were earned pro rata over the employee's work year. The portion of a vacation taken but not earned had to be refunded if the employee did not complete the anniversary year of service.

Generally, vacation time could not be carried over from one calendar year to another and was forfeited if not used. However, if employees were unable to use all of their vacation time during a particular year because of compelling business reasons, they were permitted to use it during the following year. Moreover, some members of Taxpayer-Group permitted certain union employees either to carry over their vacation time or to work and receive vacation pay in lieu of time off. Also, the law of at least one of the States in which Taxpayer-Group had operations required employers to pay their employees for already-earned vacations, regardless of the existence of a use-or-lose provision in the applicable vacation plan.

To ensure minimal disruptions of business operations and proper coverage of each retail outlet or business unit, limitations were placed on the employees' scheduling of their vacations. Vacation time had to be scheduled in advance and approved by the employee's supervisor. Supervisors ensured that employees scheduled their vacation time.

Within 2½ months after the close of each of the taxable years at issue, Taxpayer purchased irrevocable, unsecured standby letters of credit to secure Taxpayer-Group's promises to pay vacation benefits, sick pay benefits, and short-term disability benefits accrued for its taxable year ending prior to the date on which the letters of credit were purchased. Under applicable bankruptcy law, Taxpayer-Group's general creditors had no rights with respect to payments made or to be made under the letters. Contemporaneously with its purchases, Taxpayer scheduled periodic decreases in the amount of benefits to be covered by the letters.

Although Taxpayer-Group's employees, as a class, were designated as the sole beneficiaries of the letters of credit, Taxpayer appointed a bank that did not issue any of the letters to act as the employees' agent in transactions arising under the letters. Taxpayer-Group's employees and their unions were not told about the existence of the letters of credit, nor were they told about the appointment of an agent on their behalf.

Under the claims procedure established for the letters of credit, application would have needed to have been made to six different banks to obtain full payment of a single delinquent benefit. Taxpayer was required to reimburse draws against the letters within 24 hours. No draws were ever made.

Taxpayer-Group was extremely solvent. There were no contractual or other requirements (union or otherwise) obligating the securitizations. Rather, the securitization transactions were explicitly marketed to Taxpayer (and many others) as tax-benefit devices.

In most instances, what would have been the banks' customary issuance fees for comparable letters of credit were waived for Taxpayer, and Taxpayer's effective annual interest cost for the purchases was one-tenth of one percent. None of the banks issuing letters maintained a list of the employees who were covered by their letters.

Under the Plan and the Trust Agreement, certain members of Taxpayer-Group were obligated to make monthly contributions, equal to the following month's anticipated vacation pay outlay, to a nonexempt employees' trust. Vacation benefits could be paid either directly to employees from the trust or, as was the usual practice, directly to employees by a member of Taxpayer-Group, which was then reimbursed by the trust. Taxpayer-Group's promises to pay benefits funded under the Plan and the Trust Agreement were secured by the letters of credit.

Taxpayer-Group never evidenced "transfers of property" on its employees' paystubs and never withheld or paid employment taxes with respect to the transfers.[2]

---

[2] Under section 83(a) of the Code, if, in connection with the performance of services, property is transferred to anyone other than the service recipient, the excess of the fair market value of the property over the amount paid for the property is included as compensation income in the service provider's gross income for the first taxable year in which the rights to the property are transferable or not subject to a substantial risk of forfeiture ("substantially vested"). For this purpose, the fair market value of the property is determined on the date that the rights to the property become substantially vested and without regard to restrictions that lapse.

For purposes of section 83, the term "property" includes real and personal property, other than money or an unfunded and unsecured promise to pay money or property in the future. Thus, a promise to pay money or property in the future is "property" if it is either funded or secured. The term also includes a beneficial interest in assets (including money) that are transferred or set aside from the claims of creditors of the transferor; for example, in a trust or escrow account. See section 1.83-3(e) of the Income Tax Regulations.

On its return filed for each of the taxable years at issue, Taxpayer-Group deducted all employee benefits that were accrued for that year and secured as described above. When doing so, it used the "normal method of accounting" exception to the general timing-rule for deductions governed by section 83(h) of the Code.[3]

ISSUE (1) - APPLICABLE LAW AND ANALYSIS:

Section 461(a) of the Code 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.

Section 461(h) of the Code and section 1.461-1(a)(2)(i) of the regulations 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.

Section 461(h)(2)(A)(i) provides that, if the liability of the taxpayer arises out of the providing of services to the taxpayer by another person, economic performance occurs as that person provides the services.

In this case, economic performance occurred as the employee provided services to Taxpayer-Group. No issue has been raised concerning Taxpayer-Group's ability to make reasonable estimates of its vacation pay liability.

Thus, the only issues are whether the use-or-lose and termination-for-cause provisions were "conditions precedent" (so that employees had to take their vacations within the taxable year in order for Taxpayer-Group to have accrued the attributable compensation expense deductions for the year in which the vacation benefits were

---

[3] Under section 83(h), the service recipient is allowed a compensation expense deduction, under section 162, equal to the amount included, under section 83(a), in the service provider's gross income. Under the general timing rule of section 83(h), the deduction is allowed for the service recipient's taxable year in which or with which ends the service provider's taxable year in which the amount is included in gross income. Section 1.83-6(a)(3) of the regulations provides an exception to that rule: where property is substantially vested upon transfer, the deduction is allowed to the service recipient in accordance with its method of accounting (in conformance with sections 446 and 461 of the Code).

otherwise earned), or whether Taxpayer-Group's vacation pay liabilities were fixed in the taxable year in which the employees (having the requisite length of service) performed the services required to earn their vacation pay (so that the use-or-lose or termination-for-cause provisions constituted "conditions subsequent," which would require the accruals to be defeased only to the extent that employees failed to use their earned vacation benefits or were terminated for cause).

A. "Use or Lose" is a Condition Subsequent That Does Not Delay Accrual of Vacation Pay Earned Through Year-End.

There is no authority that directly considers whether a use-or-lose provision in an employment arrangement causes vacation pay that is otherwise earned by an employee to be contingent and, therefore, not accruable by the employer until the contingency is eliminated, i.e., the employee takes the vacation within the prescribed time period. However, there is ample authority analyzing whether a contingency constitutes a condition precedent, which prevents a liability from being fixed and accruable, or a condition subsequent, which merely defeases an otherwise fixed liability in the event that the contingency occurs.

The law distinguishes among the different types of contingencies to which a liability may be subject and assigns a particular effect to a contingency, depending upon how it is categorized. Some contingencies are conditions precedent that prevent satisfaction of the "all events" test and accrual of the liability until the condition is resolved. Other contingencies are conditions subsequent that defease an accrued liability only if that contingency occurs. Other types of contingencies do not prevent accrual either because they are remote contingencies or because they are not recognized as preventing accrual. As the Court noted in United States v. Hughes Properties, Inc., 476 U.S. 593, 605-606 (1986):

> There is always the possibility, of course, that a casino may go out of business, or surrender or lose its license or go into bankruptcy, with the result that the amount shown on the jackpot indicators would never be won by playing patrons. But this potential nonpayment of an incurred liability exists for every business that uses an accrual method, and it does not prevent accrual.

See also Gold Coast Hotel & Casino v. United States, 158 F.3d 484 (9th Cir. 1998) (an accrual method casino could deduct the value of slot club points won by a club member for the year in which the member accumulated the minimum number of points necessary to redeem a prize; the casino's liability was not rendered conditional by the possibility that some of the points accumulated by members might go unredeemed); Helvering v. Russian Finance Construction Corp., 77 F.2d 324 (2d Cir. 1935) (where a contract had a fixed price component, due when ore was to be delivered, and royalties of $2 per ton were payable ten years after the agreement was signed, but subject to cancellation if one of three contingencies occurred, the liability to pay royalties arose

upon delivery of the ore, and the contingencies were conditions subsequent).

In applying the foregoing principles to Taxpayer-Group's use-or-lose provisions, it is clear that the only vacation pay to which those provisions applied was vacation pay that its employees had already earned by performing services. There was nothing further for the employees to do to earn their vacation pay, assuming that their time-in-service requirements were met. The members of Taxpayer-Group became absolutely liable for the payment of vacation pay when the services that earned that vacation pay were performed. A failure to claim vacation pay that has already been earned is an act that defeases a properly accrued liability, which means that such a failure is a condition subsequent.

B. Certain Dicta in the American Stores Case are not Controlling Here.

The examining officer suggests that certain dicta in American Stores Company v. Comm'r., 108 T.C. 178 (1997), require that Taxpayer-Group's vacation pay deductions be deferred until the year in which its employees take their vacations. In American Stores, the petitioner accrued and deducted, under former section 463 of the Code, all vacation benefits that it expected to pay within 8½ months after the close of its taxable year ending January 30, 1988. Prior to its repeal, section 463 permitted taxpayers to elect to establish a reserve account for the accrual of vacation benefits and authorized a deduction for vacation pay earned before the close of the taxable year that, because of contingencies, would not be deductible under section 162(a) as an accrued expense. The court upheld the disallowance of current deductions for the vacation benefits to the extent that those benefits were not based on services performed before the end of the taxable year. Thus, the court held that "earned" vacation benefits were those attributable to services performed by employees before the end of the taxable year.

In response to the petitioner's argument that the Commissioner's interpretation rendered section 463 meaningless, the court, in dicta, referred to a "strict accrual doctrine" and Revenue Ruling 54-608, 1954-2 C.B. 8. The court stated that "[s]trict accrual would prohibit any deduction if a possibility existed that the vacation benefits could be forfeited after the end of the taxable year." *Supra* at 204-205. The court concluded that the Commissioner did not rely on a strict accrual doctrine, which would have been in contravention of section 463, noting that, if she had, no deduction for

earned vacation benefits would have been allowable unless they were actually paid due to the possibility that benefits could be forfeited after the end of the taxable year under the applicable vacation plan's "use-or-lose" provision.

However, we have concluded that the court's interpretation of Revenue Ruling 54-608 is erroneous. We reach these conclusions because the court's statements are both dicta and inapposite to its holding that vacation pay attributable to services performed after the close of an employer's taxable year and before its extended due

date for filing a return is not "earned" for that year within the meaning of section 463.

Further, the Tax Court's statement conflicts with the definition of a "vested vacation pay plan" found in the regulations under section 463. The court states that the taxpayer could not accrue even "vested" benefits under the strict accrual doctrine. In contrast, the regulations under section 463 provide that vacation pay will be considered vested accrued vacation pay (and therefore not contingent) even though there is a limit or ceiling on the amount of vacation pay that an employee is entitled to as of the close of the plan year. *See* section 1.463-1T(f) of the Temporary Income Tax Regulations.

C. Revenue Ruling 54-608 Does Not Delay Accrual When Applied to the Facts of the Instant Case.

1. Revenue Ruling 54-608 Does Not Address Use-or-Lose Provisions.

Revenue Ruling 54-608 revoked I.T. 3956, 1949-1 C.B. 78, and modified G.C.M. 25261, 1947-2 C.B. 44. None of these rulings involved a use-or-lose provision. Rather, they focused on the effect of plan provisions under which terminated employees would lose vacation pay entitlements; in none of these rulings was a forfeiture of vacation benefits possible due to the failure to use them.

I.T. 3956 dealt with the accrual of vacation pay under certain railroad contracts. Employees working 160 days or more in the preceding taxable year were entitled to a vacation in the succeeding taxable year. At issue was the termination clause of the contract, which provided that no vacation pay (or payment in lieu thereof) was owed to an employee whose employment relationship was terminated prior to the taking of a scheduled vacation. Specifically, the Service stated:

> "[t]his circumstance [referring to the possibility of the loss of vacation pay by termination of the employment relationship], however, will not preclude the accrual of vacation pay at the end of the taxable year in which services are performed, since, with respect to the individual employee at the end of such year, the employer would be justified in anticipating that the liability will be paid ... or, with respect to the employees as a group, such circumstance would only make uncertain the ultimate amount of liability to the group ...."

I.T. 3956 concludes that the liability for vacation pay was fixed as of the close of the taxable year in which the qualifying services were rendered. Forfeiture of vacation pay through non-use was impossible, because employees who were not allowed to schedule their vacations were paid an allowance in lieu of their vacations.

In Tennessee Consolidated Coal Co. v. Comm'r., 15 T.C. 424 (1950), a calendar

year taxpayer accrued vacation pay on a monthly basis. The employment contracts provided that "[a]ll mine workers with a record of twelve (12) months continuous employment ... immediately preceding June 1 ..." would be entitled to a vacation of one week per year. The Service restricted the petitioner's vacation pay deductions to amounts actually paid during the taxable year in question, on the grounds that only employees on the payroll on June 1 were eligible for vacation pay; that strikes were possible (which violated the contract); and that increases in vacation pay were possible. The court held that the petitioner's liability for vacation payments did not become certain until the date specified in the contracts, and that, thus, such liability depended upon a condition precedent: *i.e.*, whether the individual miner was working for petitioner on the date required in the contract and had complied with the contract's requirements. No use-or-lose provision was mentioned.

In Revenue Ruling 54-608, the Service revoked I.T. 3956 and, in accordance with Tennessee Consolidated Coal,[4] *supra*, held that no accrual of vacation pay can take place until (i) the fact of liability to a specific person has been clearly established and (ii) the amount of the liability to each individual is capable of computation with reasonable accuracy. The revenue ruling was given prospective application and was applicable only to taxable years ending on or after June 30, 1955.[5]

---

[4] The ruling also cites Morrisdale Coal Mining Co. v. Comm'r., 19 T.C. 208 (1952), Commissioner's appeal withdrawn, (3d Cir. 1955); and E.H. Sheldon & Co. v. Comm'r., 19 T.C. 481 (1952), *aff'd in part* (on this issue), (6th Cir. 1954). These cases are not analyzed, because the issue is either the same as in Tennessee Consolidated Coal or is not relevant to the issue presented in this technical advice request.

[5] The application of Rev. Rul. 54-608 was delayed by Rev. Rul. 55-246, 1955-1 C.B. 68; Rev. Rul. 56-315, 1956-2 C.B. 304; Rev. Rul. 57-28, 1957-1 C.B. 193; and Rev. Rul. 57-325, 1957-2 C.B. 302. Congress further delayed the application of Rev. Rul. 54-608 by enacting section 97 of the Technical Amendments Act of 1958, Pub. L. No. 85-866, which provided that:

> Deduction under section 162 ... for accrued vacation pay, computed in accordance with the method of accounting consistently followed by the taxpayer in arriving at such deduction, shall not be denied ... solely by reason of the fact that [the requirements of Rev. Rul. 54-608 have not been met] ... if at the time of the accrual the employee in respect of whom the vacation pay is accrued has performed the qualifying service necessary under a plan or policy ... which provides for vacations with pay to qualified employees.

See 1958-3 C.B. 320. Congress repeatedly extended the delay in application of

Further, in Revenue Ruling 58-18, 1958-1 C.B. 237, the subject vacation pay plan contained a use-or-lose provision: the plan expressly provided that no cash payments would be made in lieu of vacations to employees. Under that plan, salaried employees who were employed on December 31, 1954, and who had completed more than six months of service on that date, were entitled to a vacation with pay in 1955. Provisions were made for unused vacation payments to eligible employees who, after December 31, 1954, and before taking a vacation, were laid off or discharged, or retired, resigned, entered military service, or died.

Revenue Ruling 58-18 holds that the fact that there is no written contract for the payment of vacation pay does not, in and of itself, prevent the accrual and deduction of the liability for the year in which the liability is established. The ruling also suggests that a use-or-lose provision will not prevent accrual of the liability, because it states as a fact that "[t]he liability of the corporation therefor as of December 31, 1954, was clearly established, and the amount of the liability to each individual employee was capable of being computed with reasonable accuracy."

In Masonite Corp. v. Fly, 61-1 U.S.T.C. ¶9355 (S.D. MS 1961), the taxpayer's labor contract also contained an explicit use-or-lose provision. However, the court did not analyze that provision but, instead, focused on the Tennessee Consolidated Coal decision and the provision in the taxpayer's contract disqualifying employees who resigned or were discharged from receiving vacation pay. The court distinguished the taxpayer's contract from the Tennessee Consolidated Coal contract and held that the provision regarding resigned or discharged employees was a condition subsequent. It found that the taxpayer's contract did not require employment on January 1st as a condition precedent to liability; rather, it found that January 1st was merely a date for the measurement of service: *i.e.*, any employee not continuously employed for one or more years until January 1st would not be entitled to vacation pay in the year beginning January 1st. And, by allowing the deduction for the year in which the services were performed, the court implicitly recognized the use-or-lose provision as a condition subsequent as well.

2. Taxpayer-Group's Contracts are Distinguishable from the Contract that was the Subject of Revenue Ruling 54-608.

Unlike the vacation benefits analyzed in Revenue Ruling 54-608, the vacation benefits earned by Taxpayer-Group's employees were properly accruable under the

---

Rev. Rul. 54-608 until 1974, when the delay was, effectively, made permanent by the enactment of section 463, which was an elective provision dealing specifically with vacation pay accruals. Pub. L. 93-625, 93d Cong., 2d Sess. (1974).

standards articulated in Revenue Ruling 54-608 as to each specific employee, once that employee earned vacation pay by performing services and met the requisite time-in-service requirements. The time and date requirements found in the Tennessee Consolidated Coal contract were conditions precedent: no earning of a portion of the allotted vacation was possible, and employees could not earn vacation pay unless they were actually employed on June 1st. In contrast, under Taxpayer-Group's contracts, the vacation pay was earned through the provision of services, and, thus, the possibility of forfeiting that vacation pay was a condition subsequent.

The legislative history underlying section 463 indicates that the reason for revoking I.T. 3956 was the enactment of section 462. Section 462 provided for the deduction of additions to reserves for certain estimated expenses, including vacation pay accrued on a completion-of-qualifying-service basis. It was concluded that it was no longer necessary to maintain the administrative position of I.T. 3956, which allowed accruals on the basis of employees as a group. Thus, by revoking I.T. 3956, Revenue Ruling 54-608 reduced the scope of permissible accruals to those liabilities that were fixed with regard to specific employees.[6] *See* Senate Report No. 93-1357, 1975-1 C.B. 521-522.

In Taxpayer-Group's case, the accruals were determined as to specific employees. Each employee's anniversary date was the date of reference for determining his or her vacation pay, and the employee's vacation pay was earned pro rata once the minimum service requirement was met.

Accordingly, we conclude that the type of "group" accrual that Revenue Ruling 54-608 was designed to eliminate is not present in this case.

D. "Termination for Cause" is a Condition Subsequent That Does Not Delay Accrual of Vacation Pay Earned Through Year-End.

As was the case with the use-or-lose provisions, the only vacation pay to which these provisions applied was vacation pay that the employees had already earned by performing services. There was nothing further for the employees to do to earn the vacation pay at issue, assuming that their time-in-service requirements were met. Taxpayer-Group became absolutely liable to pay vacation pay to its employees when the services that earned the vacation pay were performed. A loss of earned vacation pay through a termination for cause is an act that defeases a properly accrued liability and is, therefore, a condition subsequent.

---

[6] It was thought that taxpayers accruing vacation pay under plans that did not meet the requirements of the "strict accrual rule" set forth in Rev. Rul. 54-608 would utilize section 462.

E. <u>The Termination for Cause Provisions Did Not Cause Accrual to be Delayed under Revenue Ruling 54-608</u>.

Unlike use-or-lose provisions, the effect of termination for cause provisions has been examined by the courts and the Service. In I.T. 3956, discussed above, the liability for vacations with pay (or pay in lieu thereof) was terminated if the employment relationship was terminated prior to the scheduled vacation. The Service concluded that this possibility did not preclude the accrual of vacation pay at the end of the taxable year in which the services were performed. *See also* Masonite Corp. v. Fly, *supra*, (a termination for cause provision was a condition subsequent).

As noted above, Revenue Ruling 54-608 revoked I.T. 3956. However, although both Taxpayer-Group's contracts and the Tennessee Consolidated Coal contracts had provisions that caused employees terminated for cause to lose any earned but unused vacation, the other terms of the contracts differed, which leads to a different result in this case.

In the Tennessee Consolidated Coal contracts analyzed in Revenue Ruling 54-608, the time and date requirements were conditions precedent. Those contracts required one year's continuous employment as of June 1, which prevented any accrual of vacation pay by the end of the taxpayer's taxable year, December 31. No earning of a portion of the allotted vacation was possible, and employees could not earn vacation pay unless they were actually employed (i.e., not previously terminated) on the following June 1.

In contrast, under Taxpayer-Group's contracts, the vacation pay of each individual employee was earned by the employee's provision of services, and the possibility of forfeiture by a termination for cause was a condition subsequent. Thus, although it can be argued that Revenue Ruling 54-608 is controlling as to termination-for-cause provisions, upon close examination, it is clear that, under the standards articulated in Revenue Ruling 54-608, the vacation pay earned by employees under Taxpayer-Group's contracts was properly accruable for the year in which the attributable services were performed. This is because the possible loss of earned vacation pay through a termination for cause was a condition subsequent, and because the accrual was for a specific person who had earned the vacation pay by performing services and had met the requisite time-in-service requirements, rather than for a "group."

<u>ISSUE (2) - APPLICABLE LAW AND ANALYSIS</u>:

In general, a transaction will be respected for tax purposes if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." Frank Lyon Co. v. United States, 435

U.S. 561, 583-84 (1978); James v. Comm'r., 899 F.2d 905, 908-09 (10th Cir. 1990). In assessing the economic substance of a transaction, a key factor is whether the transaction has any practical economic effect other than the creation of tax deductions. Courts have refused to recognize the tax consequences of a transaction that does not appreciably affect the taxpayer's beneficial interest except to reduce tax. The presence of an insignificant pre-tax profit is not enough to provide a transaction with sufficient economic substance to be respected for tax purposes. Knetsch v. United States, 364 U.S. 361, 366 (1960); ACM Partnership v. Comm'r., 157 F.3d 231, 248 (3d Cir. 1998); Sheldon v. Comm'r., 94 T.C. 738, 768 (1990). *See also* Rev. Rul. 99-14, 1999-13 I.R.B. 3.

The factors that we considered in analyzing Taxpayer's securitization transactions can be summarized as follows:

First, the transactions were explicitly marketed to Taxpayer as tax-benefit devices.

Second, Taxpayer-Group was extremely solvent, so there were no ascertainable nontax-financial concerns motivating Taxpayer to enter into the transactions.

Third, there were no contractual or other requirements (union or otherwise) obligating Taxpayer to secure its promises to pay benefits.

Fourth, putting Taxpayer-Group's employees' minds at rest about Taxpayer-Group's ability to pay the subject benefits could not have been a motivation for the transactions, because Taxpayer-Group never told its employees or their unions about them.

Fifth, "providing an employee benefit" through securitization of the pre-existing promises to pay benefits could not have been a meaningful motive here. Perhaps most telling in this regard is the fact that Taxpayer consistently refrained from securing benefits that were to be paid within 2½ months after the close of its taxable year for which they were accrued -- benefits that, under the rules of section 404(a)(5) of the Code, were already deductible for the taxable year for which they were accrued without resort to letters of credit.

Sixth, Taxpayer never revealed the existence of the letters of credit to its employees or their unions. By doing that, it sacrificed the goodwill that it presumably would have earned from publicizing a "new, cost-free employee benefit."

Seventh, the banks issuing the letters did not maintain a list of the employees covered by the letters.

Eighth, if, due to Taxpayer's scheduled decreases in the amount of benefits covered by the letters, the total amount of secured benefits dropped below the amount of unpaid benefits, uncertainty would have arisen about whether any particular employee's benefits were, as of that moment, fully secured.

Ninth, the banks' customary letter of credit issuance fees were, in most cases, waived for Taxpayer, and Taxpayer's effective interest cost on the transactions was one-tenth of one percent. In this regard, commercial realities (*i.e.*, arm's-length bargaining) would dictate that these discounts were offered because the letters of credit produced no meaningful economic risks to the banks: *i.e.*, would the banks have entered into these transactions on such terms if they considered their economic risks to be significant?

Tenth, the purported nontax economic benefit inuring to Taxpayer (*i.e.*, providing its employees with a compensatory, albeit uncommunicated, securing of its promises to pay benefits) was so incremental as to make the game not worth the candle. The only way that Taxpayer could ever hope to recover its transaction costs was through the tax benefits achieved through acceleration of its deductions for unpaid benefits.

Eleventh, because draws against the letters of credit had to be reimbursed by Taxpayer within 24 hours, the economic positions of Taxpayer and issuing banks, in terms of their respective liabilities to pay benefits, were not materially altered by the purchases.

Twelfth, the claims procedures under the letters of credit were nonsensical: the employees (or their agent) would have had to apply to six different banks to obtain full payment of a single delinquent benefit. Seemingly, the employees could have merely threatened that action, waited 24 hours, and immediately received payment in full from the funds that Taxpayer ostensibly obligated itself to raise to reimburse those banks.

Alternatively, rather than bothering to apply to six different banks to obtain full payment of a single delinquent benefit, the employees of certain members of Taxpayer-Group could have received full payment of those benefits from the employees' trust: *i.e.*, the employees' unions would have forced the trustee of delinquent funded benefits to simply pay them to the employees. In such cases, it seems that the trustee would have had to pay the employees, then the banks would have had to reimburse the trust, and then Taxpayer would have had to reimburse the banks.

Thirteenth, from both Taxpayer's and its employees' perspectives, the purchases of letters of credit did not cause any change in Taxpayer's historical methodology of paying benefits. Stated another way, had one stood on top of the world and looked

down on these transactions, one would have seen benefits being paid just as if no letters of credit had ever been purchased.

Fourteenth, in contrast to Taxpayer’s suggested "confirmation" of the substance of these transactions, *i.e.*, "income tax consequences to its employees" (see below), by its deliberate acts of omission, Taxpayer demonstrated that it never intended that such consequences should ever take place: Taxpayer never evidenced "transfers of property" on its employees’ paystubs and never withheld or paid employment taxes with respect to the transfers.

Looking at these 14 factors, we conclude that Taxpayer’s purported nontax motivations for purchasing letters of credit essentially vanish in the shadow of its anticipated tax benefits. Accordingly, we conclude that Taxpayer’s nontax motives for securing its promises to pay employee benefits do not support the conclusion that those securitization transactions had any nontax business purpose that would be sufficient to cause them to be respected for federal tax purposes.

Additionally, we conclude that the objective economic realities of the transactions, viewed as a whole, demonstrate that both Taxpayer and the issuing banks clearly understood that the letters would never be drawn upon. In turn, this supports the conclusion that the transactions lacked the potential for any significant economic consequences other than the creation of tax benefits. Thus, we conclude that the economic substance of the transactions was insufficient to cause them to be respected for federal tax purposes.

In summary, we conclude that Taxpayer's purchases of letters of credit to secure Taxpayer-Group's promises to pay employee benefits lacked a sufficient nontax business purpose and sufficient economic substance to cause them to be respected for federal tax purposes.

Taxpayer argues that the business purpose and economic substance requirements either do not apply to compensatory transactions or, if they do, are presumptively satisfied in the case of employee compensation. Specifically, Taxpayer’s submission states as follows:

> The provision of compensation to the employees is a business purpose that gives the letter of credit transaction economic substance. The substance of the transaction is confirmed by the fact that it has income tax consequences to its employees as well. The economic substance and business purpose doctrines have no application to an employer's decision to provide compensation to its employees. As long as the transaction results in compensation that is paid for personal services actually rendered and is reasonable in amount, it is by definition deductible compensation. [Treas.] Reg. §1.162-7(a). Thus, as long as a transaction

> is truly compensatory, the compensatory aspect of the transaction provides the transaction with both a business purpose and economic substance, and there is no need to further delve into either the economic substance or the business purpose doctrine.

In analyzing this argument, it is important to keep in mind that the employee benefits ultimately being paid are not the compensation at issue. Rather, it is Taxpayer-Group's ostensibly compensatory decision to secure its promises to pay those benefits that is at issue.

The first element of Taxpayer's argument is that the business purpose and economic substance doctrines do not apply to compensatory transactions. We note that, although the court cases applying those doctrines generally involve deductions for interest, depreciation, or losses, the principles by which those cases have been decided are expressed in broad terms that are not limited in application to any particular provisions of the Code. For example, in ACM Partnership v. Comm'r., the Third Circuit stated that "the Tax Court's analysis properly rested on economic substance cases applying provisions which, like those relevant in this case, do not by their terms require a business purpose or profit motive." *Supra* at 253. Accordingly, we conclude that Taxpayer's position on this point is incorrect. Simply put, there is no indication in the case law that the doctrines do not apply to purportedly compensatory arrangements that lack any practical economic effect other than the creation of tax losses.

The second element of Taxpayer's argument is that the doctrines are presumptively satisfied in compensatory transactions. We agree that, unless a compensatory amount is unreasonable, the Internal Revenue Service ordinarily does not question an employer's business decisions about compensating its employees. However, it does not follow that the Service is precluded, as a matter of law, from ever considering the underlying reality of compensation arrangements. Stated another way, simply labeling a transaction as compensatory in purpose will not cause it to be respected for federal tax purposes if there is insufficient economic reality to the arrangement.

Accordingly, we have concluded that the business purpose and economic substance doctrines apply to determine whether a compensation-related transaction should be respected for federal tax purposes.

We note here that we are not revisiting the issue considered in Schmidt Baking Co. v. Comm'r., 107 T.C. 271 (1996) (*i.e.*, whether a section 83(a) inclusion event upon securitization of benefits constitutes receipt of those benefits by employees for purposes of determining whether an employer's deduction for the benefits is subject to section 404 of the Code). In Schmidt, the parties stipulated that the securitizations constituted "transfers of property" for purposes of section 83. In contrast, here we are analyzing the facts of a similar transaction under tax doctrines of general applicability

that were not considered by the Schmidt court in light of the stipulation in that case.

THE TAX CONSEQUENCES OF OUR ANALYSIS OF ISSUE (2):

Having concluded that Taxpayer's purchases of letters of credit should not be respected for federal tax purposes, we therefore conclude also that, by purchasing the letters of credit, Taxpayer made no "transfers of property" under the rules of section 83 of the Code. Absent a section 83 transfer within 2½ months after the end of Taxpayer's taxable year in which the relevant services were performed, we do not reach the issue addressed by the Tax Court in Schmidt Baking. Instead, we proceed directly to analyze Taxpayer-Group's deductions under the rules of section 404.

Section 404(a) provides that compensation paid or accrued by an employer on account of any employee under a plan deferring the receipt of such compensation is not deductible under Chapter 1 of the Code, but, if it would otherwise be deductible, is deductible only under section 404, subject to the limitations of that section.

Section 404(a)(5) of the Code provides that payments by an employer to employees under a nonqualified deferred compensation plan are deductible by the employer for the employer's taxable year in which they are includible in the employees' gross incomes. See also section 1.404(a)-12 of the regulations. However, in the case of a plan in which more than one employee participates, deductions are allowed under this section only if separate accounts are maintained for each employee. Section 404(a)(5) also provides that vacation pay that is treated as deferred compensation is deductible for the taxable year of the employer in which it is paid to the employee.

Q&A-2 of section 1.404(b)-1T of the Temporary Income Tax Regulations addresses the question of when a plan, or method or arrangement will be considered to defer the receipt of compensation or benefits for purposes of section 404(a). Specifically, a plan, or method or arrangement defers the receipt of compensation or benefits to the extent that it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. This determination is made separately with respect to each employee and each amount of compensation or benefit. See Q&A-2(a) of section 1.404(b)-1T.

Under Q&A-2(b)(1) of section 1.404(b)-1T, a plan, or method or arrangement is presumed to be one deferring the receipt of compensation for more than a brief period of time after the end of the employer's taxable year to the extent that an employee receives compensation after the fifteenth day of the third calendar month following the end of the employer's taxable year in which the related services were rendered ("the 2½ month period"). Thus, for example, a year-end bonus received beyond the 2½ month period by one employee is presumed to constitute payment under a plan deferring the receipt of compensation for that employee, even though bonus payments to all other

employees are not similarly treated because they are received within the 2½ month period. Benefits are "deferred benefits" if, assuming the benefits were cash compensation, such benefits would be considered deferred compensation.

Thus, analyzing the transaction without regard to Taxpayer's purchases of letters of credit, we conclude that, to the extent that the subject benefits were not funded through the trust, they constituted deferred benefits treated as deferred compensation whose deduction by Taxpayer-Group was governed by the rules of section 404 of the Code. As a result, under section 404(a)(5), the vacation pay was not deductible until Taxpayer-Group's taxable year in which it was paid, and the sick pay was not deductible until Taxpayer-Group's taxable year within which ended the year that it was included in the employees' incomes.

Although deductions for deferred benefits are ordinarily governed by section 404 of the Code under the general rule of section 404(b)(2), there is an exception in section 404(b)(2)(B) for benefits provided through a welfare benefit fund as defined in section 419. Section 419(a) of the Code provides that contributions paid or accrued by an employer to a welfare benefit fund are deductible for the taxable year in which paid, subject to the limitation contained in section 419(b), and provided that the contributions would be otherwise deductible.

Applying the rules of section 419 of the Code, we conclude that, to the extent that the subject benefits were funded through the trust, they constituted "welfare benefits" and the trust constituted a "welfare benefit fund" under section 419 of the Code. Accordingly, section 419 governs Taxpayer-Group's deductions for benefits funded through the trust, delaying the deductions at least until the year in which the amounts are contributed to the trust.

Thus, in both situations – deferred benefits under section 404 and welfare benefits under section 419 – deductions were not available to Taxpayer-Group for the years that such benefits were earned by its employees.

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

-END-