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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

NOV. 8, 1999

Index (UIL) No.: 404.10-00
CASE MIS No;: TAM-109681-99 /CC:EBEO:B6

District Director
District

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Year Involved:

Date of Conference:

LEGEND:

Taxpayer =

Year A =
Year B =
Date 1 =
Date 2 =
X =
Y =

ISSUE:

Whether buyout payments, called • inftfal payments" and "back-and payments: made in two lump sum amounts to union employees in exchange for their yearly share of productivity funds are deferred compensation for purposes of section 404(a)(5) of the Internal Revenue Code (the "Code").

FACTS:

In Year A, Taxpayer and some of its subsidiaries entered into agreements with union employees that provided for contributions to a productivity fund each time a train operated with a reduced craw. Prior to Year A, the union agreements had called for a standard train craw of one conductor and two brakemen. The agreements allowed trains to operate with reduced crews consisting of one conductor and one brakeman. The agreements provided that the Taxpayer would make a specific payment to a productivity fund for each tour of duty that a train was operated with a reduced crew.

At the end of each year, the productivity fund was divided up and shared by the "protested employees.' Each employee's share of the fund was based on a formula contained in the union agreements and basically gave each protested employee a share in the fund for each tour of duty that the employee performed. Sharing of the productivity fund was based on all tours of duty of protected employees. whether or not on a reduced crew. No separate trust or other vehicle was established for any productivity fund. No annuities or other investment vehicles were established on behalf of protect& employees. Only active train crewmen who were members of the union as of the date of the contract, Year A, were protected employees and qualified to receive distributions from the productivity fund. Train crew members who were employed later, or employees who were promoted to conductor or brakeman did not share in the productivity fund distributions. The pmductivity fund agreements terminate only after there are no protected employees remaining in service with the Taxpayer.

New agreements were entered into between the Taxpayer and the unidn in Year B. Under these agreements, a standard. train crew was reduced in size to one conductor and one brakeman, equivalent to the reduced crew under the productivity fund agreements. In addition, protected employees in certain regions were offered the opportunity to exchange their tights under the productivity fund agreements for two lump sum buyout payments: one immediate ("initial") payment of X and one deferred (or 'back-end") payment of Y when they separated from their employer. This exchange, known as a "lump sum agreement' was submitted to a vote of the protected empjoyees on a regional basis. If a majority of protected employees in a region approved the lump sum agreement, the productivii fund was discontinued within that region and checks were issued to eligible employees for the first lump sum payments. If a majority of protected employees in a region rejected the lump sum agreement, the productivity fund was retained within the region and those employees continued to receive productivity fund payments on a yearly basis.

To be eligible for the lump sum payments, the protected employee had to be in active service as of Date 2 and have a seniority date in train service prior to Date 1. Active status was defined to include those employees who returned to service from illness, furlough, injury, suspension or dismissal. Some employees on leave for union business or disciplinary reasons did not receive their initial lump sum payment until they returned to active status.

Back-end payments are payable under all of the lump-sum agreements when the employee separates from the employer by reason of resignation, retirement, death or

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dismissal without cause. In the case of employees dismissed for cause, some lump-sum agreements pmvide that the back-end payment is forfeited, while other lump-sum agreements allow payment.

Both the lump-sum payments and the yearly productivity fund payments were processed through the payroll system. Both types of payments were treated as wages and, as such, had all applicable payroll taxes wlthheld and paid.

LAW AND ANALYSIS:

Section 404(a) of the Code pmvides. in part. that if contributions are paid by an employer on account of any employee under a plan deferring the receipt of compensation, such contributions or compensation are not deductible under Chapter 1 of subtitle A of the Code, but if they would otherwise be deductible, they are deductible under section 404. subject to the limitations contained in section 404.

Pursuant to section 404(a)(5) of the Code, contributions to a nonqualified deferred compensation plan are deductible in the taxable year in which the contribution is includible in the gross income of employees participating in the plan (or would be indudible but for an exclusion under Chapter 1 of the Code), but in the case of a plan in which more than one employee participates, only if separate accounts are maintained for each employee.

Section 404(b) of the Code provides that if there is,-no plan,, but there is a method or arrangement of employer contributions or compensation which has the-effect of a stock bonus, pension, profit-sharing, or annuity plan, or other plan deferring the receipt of compensation, subsection (a) applies as if there were such a plan. Obviously, in this case, the Taxpayer and its employees have entered into a plan, method, or arrangement for payment of the initial and back-end payments.

Section 404(a)(5) of the Code does not define compensation. The regulations, however, indicate that compensation includes an amount received in exchange for the performance of services. See, section 1.404(b)-1T, Q&A-2 of the Temporary Income Tax Regulations. In this case, protected employees entered into an arrangement that provided them with addiional compensation to reduce the impact of the Taxpayer's decision to operate trains with reduced crews. Citing to Rev. Rul. 58-301.1958-I C.B. 23 and Rev. Rul. 75-44, 1975-1 C.B. 15, which concern employment taxes, the Taxpayer contends that the subject payments are not compensation because they were paid in exchange for the employee's relinquishment of contract rights. While these revenue rulings may be relevant in the context of section 3231 (e) of the Code and its definition of compensation as remuneration for 'services rendered.' they have no direct impact when the question involves the timing of a deduction under section 404(a)(5). This is because, for purposes of section 404(a)(5), the term 'compensation" is broadly

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construed. See, Albertson's v. Commissioner, 95 T.C. 415 (1990), affd 42 F.3d 537 (9th Cir. 1994).[1]

In this case, the subject payments represent additional compensation for personal services deductible under the rules of section 464(a)(5).

While not determinative for section 404(a) timing of deduction purposes. the buyout payments are also consistent with the definition of compensation for employment tax purposes.

There are four Circuits that view similar payments as wages: STA of Baltimore -- ILA Container Royalty Fund v. United States, 621 F.Supp. 1567 (1985), aff'd, 804 F.2d 296 (4th Cir. 1986); NYSA-ILA Container Royalty Fund by Bowers v. Commissioner, 847 F.2d 50 (2d Cir. 1988); Lane Processing Trust v. United States, 25 F.3d 662 (8th Cir. 1995); Sheet Metal Workers Local 141 Supplemental Unemolovment Benefit Trust Fund v. United States, 64 F.3d 245 (6th Cir. 1995).

In STA of Baltimore, the container royalty fund was created pursuant to a collective bargaining agreement in order to protect longshoremen from loss of employment caused by containerization (when use of bulk containers eliminated the need for piecemeal loading and unloading of cargo onto ships). The employers contributed to the container royalty fund based on the tonnage of cargo handled. At the end of the year, the fund was divided up by the number of eligible employees and distributed to the eligible employees. The Court concluded that the supplementary pay was based on services actually performed and thus remuneration for employment. The court explained that the payments represented a part of the benefit package negotiated between the employers and unions as a part of the collective bargaining agreement.

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[1] In Albertson's, certain employees agreed to defer payments for future services, such as a portion of salary or bonus (or both), they would otherwise have been entitled to receive in the year services were performed. Bookkeeping accounts were maintained for each of these employees. These accounts reflected the deferred amounts plus an additional amount designated as interest. Rejecting the argument that the amounts designated as interest were deductible under section 163 of the Code, the Tax Court held that these amounts represented additional compensation for personal services deductible under section 404(a)(5). The Ninth Circuit, affirming this decision, stated that allowing the taxpayer to deduct these amounts prior to the actual receipt by the employees would "contravene the dear purpose of the taxation scheme governing deferred compensation arrangements.' 42 F.3d at 545. In reaching these conclusions, both courts recognized that the purpose of section 404 is to require matching of income indusion and deduction by the employer and employee. Allowing an accrual method taxpayer to deduct amounts characterized as interest in advance of inclusion by the employees would frustrate the matching principle of section 404.

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The court also explained that the basis upon which remuneration is paid is generally immaterial in determining whether or not the remuneration constitutes wages. Were the law otherwise, parties to a collective bargaining agreement could in effect determine which portion of an employee's compensation would be included in the social security wage base.

In Sheet Metal Workers Local 141, pursuant to a collective bargaining agreement. a supplemental unemployment benefit trust fund was established. The purpose of the fund was to provide supplemental unemployment benefits, accident and sidmess disability benefits, and severance pay to union members who were involuntarily unemployed. When the fund was terminated, all the assets were distributed to the employees. The employer in Sheet Metal Workers Local 141 sought to distinguish its case from NYSA-ILA Container Royalty Fund and Lane Processing Trust on the grounds that the holdings in those cases turned on a finding that the trust fund payments were directly attributable to services rendered to employers. Those cases had held that payments from the funds to employees were payments in remuneration for past services. The employer in Sheet Metal Workers Local 141 contended that its payments did not depend on the employees' relationship with the employers, but rather their union status and years of participation in the fund. The Court rejected this distinction and agreed that receipt of a payment was directly contingent on past or present employment. These three cases focused on the trust funds' "eligibility" requirements to determine whether a payment to an employee was remuneration for past or present services. The Sii Circuit, after considering the reasoning of the other Circuits, agreed that eligibility requirements provide the most accurate test to determine whether a payment is truly in consideration for services.

Here, the Taxpayer's contributions to the productivity fund represent part of the compensation package agreed to by the union. The productivityfund buyout agreement is a mere modiicatiin and extension of that benefit package.

Section 1.404(a)-12(b) of the Income Tax Regulations provides that a deduction under section 464(a)(5) is allowable for a contribution only in the taxable year of the employer in which or with which ends the taxable year of the employee in which an amount attributable to the contribution is indudible in gross income as compensation, and then only to the extent separate accounts are maintained for each employee. See, section 1.404(a)-12(b)(3) of the regulations.

Section 1.404(b)-1T, Q&A-I of the regulations clarifies that any plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits (other than compensation) is treated as a plan deferring the receipt of compensation for purposes of sections 404(a) and 464(d). Thus, for example, under section 404(a) and (b), a contribution paid or incurred with respect to a nonqualified plan, or method or arrangement, providing for deferred benefits is deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the

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amount attributable to the contribution is includible in the gross income of the employee. Sections 404(a) and 494(d) of the Code apply to all compensation and benefit plans, or methods or arrangements, however denominated, which defer the receipt of any amount of compensation or benefit, induding fees or other payments.

Section 1.404(b)-1T, Q&A-2(a) of the regulations provides that a plan 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 suchcompensation or benefits are performed." Under section 1.404(b)-1T, Q&A-2(b)(1) of the regulations, a plan is presumed to defer the receipt of compensation for "more than a brief period of time 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." As an example, the regulation provides that salary under an employment contract or a bonus under a year-end bonus dedaration is presumed to be paid under a plan, or method or arrangement, deferring the receipt of compensation to the extent that the salary or bonus is received beyond the applicable 2% month-period. See also, section 1.404(b)-1T, Q&A-2(c) of the regulations.

H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess., 1160 (1984) explains that "the conferees intend that payment of bonuses or other amounts within 2 ½ months after the close of the taxable year <u>in which significant services required for payment have been. performed</u> is not considered a deferred compensation or deferred benefit plan (Emphasis added)."

Protected employees of the Taxpayer were not required to perform additional services to receive the lump sum payments but would have forfeited the right to receive them if they were not employed. On Date 2, assuming the protected employees were in active service and the lump sum payments were approved by the region; the right to receive the these payments was fully vested. Thus, significant services creating the right to the lump sum payments were fully rendered by Date 2.

CONCLUSION:

The buyout payments made in two lump sum payments to union employees in exchange for their yearly share of productivity funds are compensation for purposes of section 404(a)(5) of the Code.

Initial payments made within 2 ½ months after the close of the Taxpayer's taxable year in which an employee became eligible to receive the initial payment, Year B, are not deferred compensation under section 404(a)(5) of the Code. However, initial payments (if any) made after this 2 ½ month period are deferred compensation under section 404(a)(5).

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Regarding the back-end payments. although protected employees had a vested right to receive these payments and the services creating the right to the back-end payments were fully rendered by Date 2. these payments were not made until death, retirement, or resignation of the employee. The back-end payments made within 2 ½ months following the end of the Taxpayer's taxable year in which the related services were rendered are not deferred compensation. Thus, back-end payments made within 2 ½ months after the dose of Year B are not deferred compensation under section 404(a)(5). However, back-end payments made beyond this 2 ½ month period are deferred compensation and are deductible in the taxable year in which or with which ends the taxable year of the employer in which the back-end payments are induded in gross income by the employee.

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

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