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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL (TE/GE), NORTHEAST/MID-ATLANTIC AREA
Attn: Mark Hulse

FROM: Michael J. Roach
Chief, Qualified Plans Branch 1 CC:TE/GE:EB:QP1

SUBJECT:

This Field Service Advice responds to your request for assistance, on or about November 24, 1999, relating to the refund claim at issue in the above-referenced case. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND

Taxpayer X =
Plan =
Day 1 =
Day 2 =
Day 3 =
Date 1 =
Date 2 =
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Date 6 =
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The claim involves whether, under IRC §404(a), Taxpayer X may deduct contributions made to Plan, a 401(k) plan, on the last day of Taxpayer X's taxable year if such contributions are attributable to compensation earned after the close of Taxpayer X's taxable year. Resolution of this issue involves consideration of whether the accrual rules of §461 must be satisfied before a deduction can be properly taken under §404(a).

As you know, Rev. Rul. 90-105, 1990-2 C.B. 69, addressed the applicability of the IRC §461 accrual rules to §§401(k) and (m) contribution deductions under §404(a). More recently, this office also issued an FSA recommending that the Service not pursue the applicability of §461 to §404(a) deductions in connection with a case involving so-called §404(a)(6) grace period contributions. We

reasoned in that case that the Government's position, to deny deductions for contributions which are attributable to compensation for services that have not been rendered by the close of an employer's tax year, was well supported under the plain language of §404(a)(6) and the case law relating thereto. Although the recommendation in that FSA does not reflect the Service's legal position regarding the applicability of §461 to §404(a) deductions, we understand that Taxpayer X has argued to the examination agent handling the refund claim that that FSA reflects a change in Service position regarding the applicability of §461 to §404(a) contribution deductions.

ISSUE

Whether, under IRC §404(a), Taxpayer X may deduct contributions made to Plan on the last day of Taxpayer X's taxable year if such contributions are attributable to compensation earned after the close of Taxpayer X's taxable year.

CONCLUSION

We believe that the accrual rules of IRC §461 apply to Plan contribution deductions in this case under the "otherwise deductible" language of §404(a), and that the fact of liability requirement thereof cannot be satisfied under the above-described facts. Accordingly, we recommend that your office advise the examination agent to deny Taxpayer X's refund claim.

FACTS

Taxpayer X, an accrual basis taxpayer, maintains Plan which provides for elective deferrals, matching and discretionary profit sharing contributions. Taxpayer X operates on a taxable year ended Day 2. Plan also operated on a plan year ending on Day 2. Effective Date 2, Taxpayer X amended and restated Plan, in part, to include a prior amendment that redefined the term "plan year" as the period beginning Day 2 and ending Day 1, the day before Day 2. Thus, Plan apparently experienced a short plan year for the period Date 3 through Date 4. After the change to the definition of "plan year," Taxpayer X's taxable year and the Plan's plan year overlap by 1 day. We understand that Taxpayer X's taxable year ended Date 1 was the first tax year in which it deducted §§401(k) and (m) contributions to Plan that were attributable to compensation earned in the subsequent tax year. We also understand that, for the tax year intervening tax year ended Date 1 and tax year ended Date 2, Taxpayer X did not deduct §§401(k) and (m) contributions to Plan that were attributable to compensation earned in the subsequent tax year. We have been unable to confirm whether, in the intervening tax year, Taxpayer X deducted §§401(k) and (m) contributions to Plan that were attributable to compensation earned during that tax year.

On Date 2, Taxpayer X made a contribution to Plan, $K of which was attributable to elective deferrals and matching contributions based on compensation earned during the plan year ended Date 5. Taxpayer X claimed a deduction for this contribution on its Form 1120 filed for its taxable year ended Date 2. By notice of proposed adjustment dated Date 6, the Service proposed to disallow the portion of the contribution deduction that was attributable to compensation earned after the end of the employer's taxable year, based on Rev. Rul. 90-105 and IRC §404(a)(6). Appeals upheld the proposed adjustment. The Service issued a statutory notice of deficiency on Date 7, adjusting Taxpayer X's income, in part, by the $K §§401(k) and (m) contributions to Plan for taxable year ended Date 2. Taxpayer X paid the tax in full on Date 8, and submitted a claim for refund for the $K on or about Date 9. The claimed refund was solely attributable to the portion of the claimed Date 2 Plan contribution deduction that the Service previously denied because it was attributable to compensation earned by participants after Taxpayer X's taxable year ending Date 2.

Under Plan §§A and B, pre-tax contributions (elective deferrals) and employer matching contributions are based, in part, on the amount specified by the participants on their annual salary reduction agreements. Under §C, "...any amounts held in the Trust Fund which have not been credited to Participants' Accounts under Plan as of the last day of the Plan Year shall be credited as of such date by applying such amounts in the manner described in paragraph (4) below."[1] In other words, in operation, Taxpayer X makes contributions on the first day of a plan year, Day 2 (which is also the last day of Taxpayer X's taxable year), and the amounts remain in the trust unallocated until allocated at some later date within the plan year, as determined by the plan committee. Plan §§D and C.

Under Plan §E, contributions attributable to elective deferrals, as described in §401(k), are only required to be made to Plan in the amount the participant's compensation has been reduced pursuant to the salary reduction agreement between Taxpayer X and the participant. Under Plan §F, the term "compensation" includes basic compensation paid to a participant during any plan year. Under Plan §G, matching contributions generally are contributed in an amount equal to H percent of the amount the participant elected to defer pursuant to the salary reduction agreement between Taxpayer X and the participant (subject to certain reductions and limitations specified in Plan). Under Plan §J, eligible employees who want to make elective deferrals to Plan must enter into a written salary

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[1]Paragraph (4) provides in general that forfeitures shall be applied to restore prior forfeitures, to defray administrative costs of the plan, and if funds remain, to the matching contribution accounts of remaining active participants in lieu of matching contributions which otherwise would have been made on or after the date of the forfeiture.

reduction agreement with Taxpayer X which is generally applicable to payroll periods commencing on or after the date the agreement is executed.

Under Plan §K, amounts contributed to Plan may be refunded to Taxpayer X in the event of disallowance of a deduction or disqualification of Plan by the Service, or mistake of fact, provided such return occurs within 1 year of the disallowance, disqualification, or mistake.

We understand from the examination agent reviewing the refund claim that $J of the $K disallowed was not allocated to plan participants during the Date 2-Date 5 plan year in accordance with the terms of Plan. However, the rider to Form 1120X submitted with Taxpayer X's claim for refund states that the $K was allocated to participant accounts during the Date 2-Date 5 plan year.

The examination agent reviewing the refund claim has requested assistance from your office on whether to deny the claim. We have been told that Plan has a favorable determination letter from the Service.

The examination agent has also indicated that Taxpayer X initially sought to deduct as a Plan contribution the interest that accrued on the Date 2 contribution before it was allocated to participant accounts. However, Taxpayer X has conceded its initial objection to that adjustment. We understand that extensions have been obtained on the statutes of limitations otherwise appropriate for the applicable Forms 1120 and 5500.

LAW

IRC § 404(a) provides as follows:[2]

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[2]Prior to the Tax Reform Act of 1986 ("TRA"86"), Pub. L. No.99-514, IRC §404(a) provided, in part, 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:...

Section 1851(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

> **(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 1]; but, <u>if they would otherwise be deductible</u>, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:... (emphasis added)

IRC §404(a)(3) provides, in part, with respect to profit sharing trusts that contributions are deductible "[i]n the taxable year when paid," if the contributions are paid into a profit sharing trust..."

Rev. Rul. 90-105 sets forth the Service's position on the deduction of IRC §§401(k) and 401(m) contributions that are attributable to compensation earned after the close of an employer's taxable year. The issue in Rev. Rul. 90-105 is stated as follows:

> "whether contributions to a qualified cash or deferred arrangement within the meaning of section 401(k) or to a defined contribution plan as matching contributions within the meaning of section 401(m) are deductible by an employer for a taxable year, if the contributions are attributable to compensation earned by plan participants after the end of that taxable year."

The Rev. Rul.'s analysis of the "otherwise deductible" requirement for deductions under §404(a) specifically concludes that the requirements of §1.404(a)-1(b) and, in the case of an accrual basis taxpayer, §461 must be satisfied in order for a contribution to be "otherwise deductible" under chapter 1 of the Code.

In the case of a contribution that is deductible under IRC §162 or §212, §1.404(a)-1(b) provides that in order to be deductible under §404(a), the

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(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." 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).

contribution must be an ordinary and necessary expense during the taxable year in carrying on a trade or business or for the production of income and must be compensation for services actually rendered. Rev. Rul. 90-105 interprets §1.404(a)-1(b) as follows:

> "In order for the Post-Year End Contributions to be deductible for M's 1989 Taxable Year, M would have been required to show that the contributions would have been deductible under section 404(a), and in turn would have been otherwise deductible under chapter 1 of the Code, for M's 1989 Taxable Year, if the contributions had actually been paid on the last day of that taxable year. However, the contributions are attributable to compensation earned by plan participants after the end of M's 1989 Taxable Year, so that as of the last day of that taxable year the payment of the contributions could not have been compensation for services actually rendered. Under section 1.404(a)-1(b) of the Regulations, the Post-Year End Contributions therefore could not have been deducted for M's 1989 Taxable Year."

In addition, Rev. Rul. 90-105 states that:

> "In addition, if M uses the accrual method of accounting, section 461(a) also would have precluded the Post-Year End Contributions from being deductible for M's 1989 Taxable Year, because all events fixing the fact of M's liability to make the contributions had not occurred as of the end of M's 1989 Taxable Year. Because the Post-Year End Contributions are attributable to compensation earned by plan participants after the end of that taxable year, the compensation could not have been actually deferred as of that date, so that M's liability to make elective deferral and matching contributions with respect to that compensation would not have been fixed."

IRC §461(a) provides that the amount of any deduction or credit allowed by subtitle A (which includes chapter 1) must be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income. For the accrual method of accounting, §461(h) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test is not treated as met any earlier than when economic performance with respect to that item occurs. Section 461(h) states that the all events test is met with respect to an item if all events have occurred that determine the fact of liability and the amount of that liability can be determined with reasonable accuracy. Section 1.461-4(d)(2)(iii) 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...." Thus, a liability with

respect to §404(a) is not incurred until the all events test is satisfied and the liability is otherwise deductible under the rules of §404.

Rev. Rul. 90-105 also cites §1.404(a)-1T, Q&A-1, §7701(a)(25) and §301.7701-16. Section 1.404(a)-1T, Q&A-1, provides that in order to be deductible under §404(a), a contribution otherwise deductible under §§162 or 212 must be paid or incurred for purposes of those sections, in addition to satisfying the other requirements for deductibility under those sections. (emphasis added) Section 7701(a)(25) states that the term "paid or incurred" shall be construed according to the method of accounting used by the taxpayer to compute its income. Section 301.7701-16 of the Regulations adopts the same definition for purposes of the Regulations.

ANALYSIS

IRC §§404(a) and 404(a)(3) expressly provide that qualified plan contributions are deductible "when paid" under §404(a) provided they would "otherwise be deductible" under chapter 1. Under Treas. Reg. §1.404(a)-1(b), in order to be deductible under §404(a), contributions must be expenses which would be deductible under §162 (relating to trade or business expenses) or §212 (relating to expenses for production of income) if it were not for the provision in §404(a) providing that they are deductible, if at all, only under §404(a). In order for a contribution to be deductible under §§162 or 212, an accrual basis taxpayer must also satisfy the requirements of §461 and the regulations thereunder. As stated above, §461(a) provides that the amount of any deduction or credit allowed by subtitle A (which includes chapter 1) must be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income. For the accrual method of accounting, §461(h) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test is not treated as met any earlier than when economic performance with respect to that item occurs. Section 461(h) states that the all events test is met with respect to an item if all events have occurred that determine the fact of liability and the amount of that liability can be determined with reasonable accuracy. Section 1.461-4(d)(2)(iii) 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...." Thus, a liability with respect to §404(a) is not incurred until the all events test is satisfied and the liability is otherwise deductible under the rules of §404.

Taxpayer X would not be obligated to contribute elective deferrals or matching contribution amounts unless the participant receives compensation for services actually rendered. See Plan §§E and F. Under the terms of Plan, eligible employees who want to make elective deferrals to Plan must enter into a written

salary reduction agreement with Taxpayer X which is generally applicable to payroll periods commencing on or after the date the agreement is executed. See Plan §G. Contributions attributable to elective deferrals, as described in §401(k), are only required to be made to Plan in the amount the participant's compensation is reduced pursuant to the salary reduction agreement between Taxpayer X and the participant. See Plan §E. Matching contributions are contributed within specified limits in an amount equal to H percent of the amount a participant's compensation is reduced pursuant to the salary reduction agreement between Taxpayer X and the participant. See Plan §B. Accordingly, all the events that establish the fact of liability as to elective deferral or matching contributions for a plan year only occur payroll period by payroll period as Taxpayer X incurs a liability for compensation for services to which plan contributions relate.

In Rev. Rul. 90-105, the Service stated its position that the condition in IRC §404(a) that the contributions "would otherwise be deductible" under this chapter means that an accrual basis taxpayer must satisfy the all-events test of §461, not merely that contributions must be ordinary, necessary and reasonable. Therefore, Rev. Rul. 90-105 indicates the Service's general position that §§401(k) and (m) contributions must satisfy the §461 accrual rules in order to be "otherwise deductible" under §404(a). Although the contributions in question in Rev. Rul. 90-105 were paid after the close of the employer's taxable year and during the so-called §404(a)(6) grace period, we note that the deduction of contributions actually paid during an employer's taxable year under §404(a) and the deduction of so-called grace period contributions paid after the close of an employer's taxable year under §404(a)(6) are both subject to the "otherwise deductible" requirement of §404(a).

In addition, the recent victories for the government in Lucky Stores v. Commissioner,153 F. 3d 964 (9th Cir. 1998), cert. denied, 119 S. Ct. 1755 (May 17, 1999), Airborne Freight Corporation v. United States, 153 F. 3d 967 (9th Cir. 1998), cert. denied, 119 S.Ct. 1755 (May 17, 1999), and American Stores Company v. Commissioner, 170 F.3d 1267 (10th Cir. 1999), cert. denied, 120 S. Ct. 182 (October 4, 1999), in the multi-employer context, are not directly applicable because they involve so-called grace period contributions under IRC §404(a)(6). In Lucky, the Ninth Circuit affirmed the Tax Court's holding that so-called grace period contributions attributable to compensation for services rendered after the close of an employer's taxable year were not deductible under the plain "on account of" language of §404(a)(6). In American Stores, the Tenth Circuit based its decision on §413(b)(7), specifically applicable only to multiemployer plans, rather than the plain language of §404(a)(6) or the "otherwise deductible" language of §404(a). Neither of the courts' holdings were based on the §461 accrual rules, as applicable either under §404(a)(6) or the more general "otherwise deductible" language of §404(a).

We have coordinated this response with CC:ITA and Employee Plans. Please call if you have any further questions.

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MICHAEL J. ROACH