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CITY BAR

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BUSINESS ENTITIES**

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The Honorable Mark J. Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
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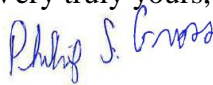
The Honorable John A. Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

**Re: New York City Bar Association Report Offering Proposals Regarding the
Deduction Deferral Rule of Section 404(a)(5)**

Dear Assistant Secretary Mazur and Commissioner Koskinen:

On behalf of the New York City Bar Association, as reported by the Committee on Taxation of Business Entities, I am pleased to submit this Report regarding the deduction deferral rule of Section 404(a)(5) of the Code. This Report discusses certain tax issues concerning the timing of deductions under Section 404(a)(5) and suggests recommendations on guidance under Section 404(a)(5) to address these issues and clarify or improve when deductions can be taken and by whom.

We would be pleased to discuss any questions you may have regarding our Report. Please contact the undersigned at (212) 880-9828 or via e-mail at pgross@kkwc.com if you would like to discuss.

Very truly yours,

Philip S. Gross
Chair

Enclosure



NEW YORK CITY BAR
REPORT OFFERING PROPOSALS REGARDING
THE DEDUCTION DEFERRAL RULE
OF
SECTION 404(a)(5)

As reported by the Committee on Taxation of Business Entities

August 10, 2016

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REPORT OFFERING PROPOSAL REGARDING
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This report,¹ which is submitted on behalf of the New York City Bar by its Committee on Taxation of Business Entities, considers the deduction timing and deferral rule of Section 404(a)(5)² and certain provisions of the Treasury Regulations promulgated thereunder. The report recommends a change to the general timing rule set forth in the regulations.

I. Introduction

Various types of acquisition transactions can create a short taxable year for an acquired corporation or partnership.³ Typically, in connection with such transactions, payments are made to employees or other service providers (collectively “employees”) that may constitute payments made under a “plan deferring the receipt of compensation” at or shortly before closing.⁴

¹ This report was prepared by an ad hoc committee of the Committee on Taxation of Business Entities of the New York City Bar. The authors of the report are Stephen P. Foley and Alan J. Tarr. Significant assistance was provided by John P. Barrie and Michael Miller.

² Unless otherwise indicated, Section references are to Sections of the Internal Revenue Code of 1986, as amended (the “Code”).

³ The most common situation is one in which the stock of a U.S. target corporation is sold. If no Section 338 or 336(e) election is made, and the acquirer is a U.S. corporation that will incorporate the target into its consolidated group, the taxable year of the target will end at the close of the day immediately prior to the closing date (if the target is an S corporation) or at the close of the closing date (if the target is a C corporation). Treas. Reg. Sec. 1.1502-76(b)(1)(ii)(A). If an election is made under Section 338(h)(10) or 336(e), the target corporation will be deemed to liquidate, thus terminating what will be its final taxable year at the close of the closing date. Treas. Reg. Secs. 1.338(h)(10)-1(d)(4), 1.336-2(b)(1)(iii). Unless the closing date is either on January 1 or December 31 (depending on whether the target year ends on the day prior to, or on, the closing date), the taxable year of a target corporation will end before the end of the calendar year.

⁴ Given the broad reach of the definition of “deferred compensation” for this purpose in Treas. Reg. Sec. 1.404(b)-1T (a plan, method or arrangement deferring the receipt of compensation “more than a brief period of time after the end of the employer’s taxable year in which the [relevant] services...” are performed), almost any payment of compensation more than 2½ months after the end of the taxable year of the employer in which the compensation is earned will constitute deferred compensation. Typical examples include simple bonus plans promising to pay a bonus or some form of “tail” payment on the consummation of a sale transaction, stock appreciation rights, and phantom stock plans, so long as such plans do not require employment at the time of the event triggering the ultimate payment. See House Ways & Means Committee Report on Section 404 of the 1954 Code, H.R. Rep. No. 83-1337 (1954), reprinted in 1954 USCCAN 4017, 4290, which stated that Section 404(b) was intended to “make it clear that if there is any arrangement deferring payment of compensation for services rendered by one or more

As described below, aside from vague language in the currently applicable Temporary Regulations on the subject, there is little published IRS or Treasury guidance on what constitutes a “plan deferring the receipt of compensation,” particularly as such term might apply to popular compensation plans, such as stock appreciation rights (“SAR”) plans or phantom stock plans. Combined with the draconian deduction limitation described below, this makes the tax treatment of a number of such widely used plans unclear at the present time.

If the payment is deemed to be one made under a “plan deferring the receipt of compensation,” under current Treasury Regulations and rulings, when a transaction creates a short taxable year for the target corporation, even if payments of deferred compensation are accrued and made by the target during the short pre-closing taxable year, the deduction of such payments is deferred to the post-closing taxable year.⁵ The reason is that the relevant regulations⁶ (subject to a very limited exception)⁷ defer the tax deduction of deferred compensation until the taxable year of the employer “with which or within which” the taxable year of the employee ends in which the employee will include the payment in income (this rule is referred to herein as the “WIW Rule”).⁸

employees...”, such a plan or arrangement would be a plan of deferred compensation, *Id.*; Rev. Rul. 55-446, 1955-2 C.B. 531 (bonus payments deferred beyond the year of related service are deferred compensation); Rev. Rul. 57-88, 1957-1 C.B. 88 (bonuses paid in respect of previous year’s services escaped characterization as a plan of deferred compensation only if “paid by ... taxpayer soon after the taxable year [in which the related services were performed]”; Rev. Rul. 61-127, 1961-1 C.B. 36 (bonus payments paid after the close of the year of related service avoided characterization as deferred compensation when paid pursuant to a plan requiring bonus payments be made within 2½ months after the close of the year of service); *Avon Products Inc. v. U.S.*, 97 F.3d 1435 (Fed. Cir. 1996) (plan in which bonuses deferred slightly beyond 2½ months after the close of the payor’s taxable year for which the bonus was granted constituted deferred compensation the deduction of which was deferred under Section 404(a)(5); and Treas. Reg. Sec. 1.404(b)-1T (discussed in text, *infra*).

⁵ An example would be an item of compensation that has become non-forfeitable (but is not paid) in year X and that is paid out shortly before the closing of the sale of the service recipient in the middle of year X + 2. Since, as discussed in text below, the compensation item is paid more than 2½ months after the close of the year (year X) in which it became non-forfeitable, the payment is a payment of deferred compensation and, thus, is subject to the deferral rule. See text at note 4, *infra*.

⁶ See Treas. Reg. Sec. 1.404(a)-12(b)(1).

⁷ The regulations except from this rule payments of “pensions” made directly to “former employees” and certain vacation accrual payments. Thus any other payments would seem to fall within the unfavorable WIW Rule. See Treas. Reg. Sec. 1.404(a)-12(b)(2) (exception) and (b)(1) (general rule). This language appears to be a very long-term holdover from the language of former Treas. Reg. Sec. 1.23(a)-9. See discussion in text at note 13, below. Additionally, the Internal Revenue Service (“IRS”) has ruled that the cash-out of nonqualified options is not subject to the WIW Rule, without citing Section 404(a)(5) or Treas. Reg. Sec. 1.404(a)-12(b). Rev. Rul. 2003-98, 2003-2 C.B. 378. However, this ruling appears to involve an implicit assumption by the IRS that compensatory stock options are simply not “deferred compensation,” and thus not captured by the rule in Section 404(a)(5). It would be an extraordinarily broad reading of the Revenue Ruling to say that it created an exception for payments of (by definition) “fully vested” cash from the Section 404(a)(5) deferred compensation deduction timing rules. Under Section 409A, options issued under certain circumstances, including options issued with in-the-money strike price, can constitute “deferred compensation” for Section 409A purposes; however, there is no evidence that this rule was intended to affect the interpretation of Section 404(a)(5).

⁸ *Id.*

No short target taxable year (unless originally a non-calendar taxable year whose first short period ends on December 31) can satisfy this test with respect to the current calendar taxable year of the employee. Thus, the deduction of all such payments in normal stock acquisition transactions are generally deferred until the post-closing stub taxable year of the target corporation, or if the transaction is a stock purchase with a Section 338(h)(10) or Section 336(e) election, are permanently disallowed due to the lack of any post-deemed-liquidation taxable year of the target corporation in all such acquisition transactions.

Specifically, if the target corporation is a domestic C corporation that will be included as a corporation in an acquiring consolidated group, only if the transaction closes on December 31 will payments of deferred compensation made by the target corporation in such year be deductible by target on its final pre-closing tax return (since, under applicable rules, the taxable year of a C corporation target entering a consolidated group ends at the close of the date on which consolidating control of the target is acquired).⁹

If the target corporation in such an acquisition is an S corporation, only if the transaction closes on January 1 of the following year will payments of deferred compensation made by the target corporation be deductible by target on its final pre-closing tax return (since, under applicable rules, the taxable year of an S corporation ends on the day before the date on which its S status is terminated by the acquisition of its stock by a C-corporation acquirer).¹⁰

Additionally, non-calendar-year employers or payers of fees to independent other service recipients (collectively, “employers”)¹¹ can suffer a deferral due to the fact that the taxable year in which payments may be made are not ones in which or with which the relevant taxable year of the payee employee (or independent contractor) ends.

Neither the governing statutory language in Section 404(a)(5) nor its legislative history requires this result. Unlike Section 83(h), which specifically incorporates the WIW Rule in the statutory language, Section 404(a)(5) merely states that, in the case of a nonqualified deferred compensation plan, the employer may deduct “in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan....”¹² As used in Section 404(a)(5), a “contribution” includes payments of deferred compensation.¹³ Moreover, the legislative history of this provision does not indicate that the WIW Rule was to apply here, in contrast to its specific reference to the WIW Rule for property whose deduction is governed by Section 83(h).¹⁴ The only language in the legislative history

⁹ Regarding nonqualified options, see note 4, above, and Treas. Reg. Sec. 1.1502-76(b)(1)(ii)(A)(1).

¹⁰ Treas. Reg. Sec. 1.1502-76(b)(4)(ii)(A)(2).

¹¹ Section 404(d) extends the principles of Section 404(a)(5) to payments made by service recipients to independent contractors.

¹² Section 404(a)(5). See also Schnee & McKinney, Independent Contractor Deferral Can Delay Deductions, 72 Practical Tax Strategies for Accountants No. 6 (June 2004) (hereafter referred to as “Schnee & McKinney”).

¹³ Id.; Albertson’s Inc. v. Commissioner, 95 T.C. 415 (1990), aff’d, 38 F.2d 1046 (9th Cir. 1993); aff’d in part reversed in part, 42 F.3d 537 (9th Cir. 1994).

¹⁴ See “Tax Reform Act of 1969, Report of the Committee on Finance United States Senate to Accompany H.R. 13270 Together With Separate and Individual Views”, S. Rep. No. 91-552, dated Nov. 21, 1969 (the “Full Finance

dealing with Section 404(a)(5) appears in the Full Senate Report, namely: “[t]he Committee provided . . . that the employer will be allowed a deduction for his contribution at the time the employee recognizes income [provided separate accounts are maintained]...” (emphasis added), with no specificity as to the taxable year, let alone any reference to the WIW Rule or a requirement that the WIW Rule be used.¹⁵ In contrast, the language in each of those reports describing the grant of restricted property, the deduction of which was to be governed by Section 83(h), was crystal-clear as to the application of the WIW Rule in such circumstances: “[t]he deduction is to be allowed in the employer’s accounting period which includes the close of the taxable year in which the employee recognizes the income. Where restricted property is not subject to the new rules governing recognition of income, existing rules regarding the amount of the deduction will continue to apply.”¹⁶

In fact, the initially proposed regulations under Section 404(a)(5), Prop. Reg. Sec. 1.404(a)-12, proposed in 1971 (the “1971 Proposed Regulations”), did not have the WIW language. Instead, the 1971 Proposed Regulations merely tracked the statutory language. The 1971 Proposed Regulations read in pertinent part:

No deduction is allowable under section 404(a) (5) for any contribution paid or accrued after August 1, 1969, by an employer under a stock bonus, pension, profit-sharing, or annuity plan or for any compensation paid or accrued on account of any employee under a plan deferring the receipt of such compensation except in the taxable year in which an amount attributable to such contribution is includible as compensation in the gross income of the employees participating in the plan, and then only to the extent allowable under section 404(a). (Emphasis added.)

Without any explanation, however, the final regulations, issued in 1978 pursuant to Treasury Decision 7554 (7/21/78), switched to the more precise (and taxpayer-adverse) WIW language, as set forth above.

These regulations, when issued, attracted little attention. However, since that time, the economy has shifted significantly to one composed more of service companies. Not only are compensation payments—including deferred compensation payments—of more importance to the earnings and balance sheets of service companies than to those of other types of companies, these companies are much larger and more typically the subject of purchase and sale transactions than they were at the time the regulations were issued. Additionally, the Treasury has recently proposed regulations under Section 1502 specifying that such payments are, in a number of circumstances, properly taken in the first short year and are not subject to the “next day” rule. Prop. Treas. Reg. 1.1502-76(b), though without appearing to override Section 404(a)(5). Accordingly, unless the Section 404(a)(5) regulations are amended, Section 404(a)(5) will defer

Report”). See also the General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Cong., P.L. 91-172, prepared by the Staff of the Joint Committee on Internal Revenue Taxation, December 3, 1970 (the “Bluebook”).

¹⁵ Full Senate Report at p. 123; Bluebook at p. 112.

¹⁶ Full Senate Report at p. 123; Bluebook at p. 112.

those very deductions back into the second, consolidated return year of the target corporation (see examples A through C in the Annex hereto), which is inconsistent with the current thrust of Treasury tax accounting policy. Accordingly, the Committee believes that a review of the Section 404(a)(5) regulations is in order, if nothing else, then as part of the process for finalizing these new proposed regulations.

Moreover, to the extent the regulatory language was originally intended to prevent abusive deferral, the scope of the intervening Section 409A rules appears to cover, in meticulous detail, all possible aspects of such abuse, which indicates that extension of the WIW rule to Section 404(a)(5) serves no policy purpose at present even if it arguably did at the time the Regulations were drafted.

Proposals

First, the Committee proposes that the scope of “plan deferring the receipt of compensation” be clarified in published guidance. The definition should be consistent with that of the existing IRS private ruling position, namely, that any payments made on or before 2½ months after the close of the taxable year in which compensation vests shall not constitute a payment under a “plan deferring the receipt of compensation.”

Second, the Committee proposes that Treasury Regulation Section 1.404(a)-12(b) be amended to provide that the deduction of deferred compensation be allowed in the first taxable year of the employer in which the date the employee recognizes income from the payment falls. This rule would effectively adopt the “exact day” rule of Section 267; namely, if the exact day of the recognition event were to occur on date x, the employer’s taxable year of deduction would be the taxable year in which date x fell, regardless of when the taxable year of either the employee or employer ended. This would prevent both unwarranted deferral or unwarranted acceleration of the deduction.

In addition, the Committee proposes that this rule confirm that a payment made on the closing date of a transaction would be deemed to have been made in the first short taxable year of the payor. Such rule would be consistent with Proposed Treasury Regulation Section 1.1502-76(b), which appears to treat such payments by a target company as deductible (absent the application of Section 404(a)(5)) in the initial short year ending with the time a target company is incorporated into the consolidated group of the buyer.

II. Discussion

Following enactment of the Revenue Act of 1942¹⁷ (the “1942 Act”), plans involving the deferral of compensation were subjected to deduction limitations. Specifically, the employer’s deduction with respect to deferred compensation and contributions to nonexempt trusts was changed pursuant to a new Section 23(p)(1)(D), which provides:

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 . . . be deductible, if [otherwise] deductible . . . under this subsection but only to the following extent:

* * *

(D) In the taxable year when paid, if the plan is not one [involving the contribution to a pension trust of some sort] . . . if the employees’ rights to or derived from such employer’s contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid.

(Emphasis added.) This rule applied until the amendments made by the Tax Reform Act of 1969¹⁸ (the “1969 Act”).

The 1969 Act changed the rule to provide that the deduction for any “plan deferring the receipt of compensation”¹⁹ would be allowed “in the taxable year in which an amount attributable²⁰ to the contribution is includible in the gross income of employees....”, regardless of whether the property “paid” was forfeitable or not at the time of “contribution” or “payment.”²¹

¹⁷ P.L. 753, 56 Stat 798 (enacted Oct. 21, 1942).

¹⁸ P.L. 91-172 (enacted Dec. 30, 1969), 83 Stat. 487 (1970).

¹⁹ Section 404(a).

²⁰ Notwithstanding the elimination of the language connecting the time of the deduction to the time when the contribution/compensation was “paid”, at least one court has indicated that the use of the word “contribution” in Section 404(a)(5) effectively continued the “payment” requirement, as well as the requirement of inclusion in the service provider’s income, see Albertson’s, supra note 13, although it is hard to see at least in the case of a cash basis taxpayer how there could be inclusion without payment.

²¹ The elimination of the requirement of “non-forfeitability” appears in practice to apply only to interests in non-exempt trusts, deductions attributable to which are also governed by Section 404(a)(5), since (i) cash by its nature (unless in a trust of some sort) is generally non-forfeitable (unless perhaps paid in escrow) and (ii) any payments in non-cash property after the 1969 Act would be governed solely by Section 83. See text, infra. In cases where the interest was nonforfeitable from the beginning, this language would not appear to have – nor would it appear to have been intended to have – any effect on or change with respect to the current deduction rules. In the case where an employee’s interest was forfeitable at the time of the contribution, the effect was generally favorable: to allow the employer a deduction where none had previously existed, but to defer that deduction to “the taxable year” in which the employee includes the income, i.e., when the interest became nonforfeitable.²¹ This new rule, like the old one, applied not only with respect to an employer’s contribution to nonexempt trusts, but also to all other nonqualified “plans” of deferred compensation. Section 402(b)(2) was amended to provide that, where an employer made

This statutory language left two questions: first, the already-existing question of what, exactly, constitutes “a plan deferring the receipt of compensation”; and, second, the new question of whether the employee income event (on which post-1969 Act deductions of plan payments were predicated) occurred in the taxable year of the employer or the employee.

(i) **Definition of “plan deferring the receipt of compensation”.** A “plan deferring the receipt of compensation” was not clearly defined in the 1942 Act; nor has it been definitively defined for these purposes since, although it clearly is construed broadly.²² The statute states that the rules of Section 404(a) apply to, among other things, “compensation paid or accrued . . . under a plan deferring the receipt of such compensation,”²³ and, additionally, “if there is no plan, but . . . there is a method or arrangement of employer contributions or compensation which has the effect of . . . [a] plan deferring the receipt of compensation . . . then [the limits of Section 404(a), including Section 404(a)(5)] shall apply as if there were such a plan.”²⁴ This latter language thus extends the reach of Section 404(a)(5) (and 404(d)) to informal and “one-off” arrangements.²⁵

The Temporary Regulations, which still are in effect,²⁶ are more helpful, but still not particularly illuminating. They state merely that a plan defers the receipt of compensation 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,”²⁷ with “more than a brief period” being defined as “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.”²⁸ The Conference Report

contributions to a nonexempt trust at a time when an employee’s interest in such trust was still forfeitable, such an employee, for the first time, was now to be subject to tax upon the lapse of the trust forfeiture conditions (all determined as if the trust interest were property subject to Section 83. A distinction between Section 402(b)(2) and Section 83(h) still remains. The employer’s deduction is only for the contribution, irrespective of any growth in value of the trust interest owned by the employee since the contribution date and presumably also irrespective of any diminution in the value of any such interest by the vesting date. Section 404(a) and Section 404(a)(5); example noted in Treas. Reg. Sec. 1.404(a)-12(b)(1); PMTA 2008-01304 (3/12/2001). In other words, it is the original contribution that is deductible; only the timing of the deduction is determined by the employee’s inclusion). *Id.* This contrasts with Section 83(h), which gives the employer a deduction equal to the value of the property on the forfeiture lapse date. *Id.*

²² See note 4, above.

²³ Section 404(a).

²⁴ Section 404(b).

²⁵ See *Schnee & McKinney, supra*, note 12.

²⁶ Treas. Reg. Sec. 1.404(b)-1T. The Temporary Regulations were promulgated in 1986. Since they were promulgated prior to 1988, they are exempt from the three-year sunset rule generally now applicable to Temporary Regulations. See Section 7805(a)(2); *Dieter Stussy v. Commissioner* 86 T.C.M. 220 (2003); see also *Schnee & McKinney, supra*, note 12.

²⁷ Treas. Reg. Sec. 1.404(b)-1T, Q&A-2(a).

²⁸ Treas. Reg. Sec. 1.404(b)-1T, Q&A-2(b)(1). For this purpose, the service provider must have received a payment by that date and, under Section 404(a)(11), such receipt must be “actual receipt”, not constructive receipt. In this respect, Section 404(a)(11) legislatively reversed the outcome in *Schmidt Baking Co. v. Commissioner*, 107 T.C.

relating to the 1984 amendment of Section 404(b) under which this regulation was drafted states that “the conferees intend that payment of ... amounts within 2½ months after the close of the taxable year in which significant services required for payment have been performed is not considered a deferred compensation or deferred benefit plan.”²⁹

Unfortunately, this leaves the status of many common long-term deferred compensation plans, such as SAR plans and phantom stock plans, in doubt. Although some such plans would permit the employee, after a “vesting period,” to receive the value of the SAR or the phantom stock or bonus upon leaving employment for any reason (though often excluding for-cause terminations), many such plans are designed as incentives to facilitate a future sale of the business and, thus, require that the payee continue his employment until the change of control. Plans permitting an employee to leave employment for any reason while still retaining the benefit would clearly appear to be deferred compensation, assuming the payout occurred more than 2½ months after the vesting year. However, as noted, other plans in fact require that services be provided right up to the date of payment in order for the payment to be received.

Although the IRS has no published rulings on this issue, it has taken the position in a private ruling that the year of vesting, and not any earlier year to which the plan is applicable, is the year in which “services [are provided] creating the right to ... compensation” for this purpose.³⁰ Accordingly, the IRS’s position appears to be that a multi-year deferred compensation plan, to the extent it provides for vesting in the last year, is not a “plan of deferred compensation,” and thus not subject to Section 404(a)(5), so long as all payments with respect to such plan are made within 2½ months after the close of that final year.³¹

For example, under the private ruling, a bonus plan deferring compensation over a five year period, with the amount fully vesting at the end of the first year, would be a plan of deferred compensation, since the first year is the last year in which the services “creating” the right to compensation would have been performed; accordingly, a payment at the end of year five would be one pursuant to a “plan of deferred compensation.” However, if the plan required the employee to remain employed through the end of the fifth year in order to be entitled to any payment, the plan would, under this private ruling, not be deferred compensation so long as the payout was made within 2½ months after the close of that fifth year.³² Similarly, if a multi-year deferred compensation plan required the employee to be employed through the date of a change of control in order to be entitled to any payment, this also would not be a plan of deferred compensation, so long as payment was made within 2½ months after the close of the taxable year of the employer in which the change of control occurred. However, since private rulings are not

271 (1996) (holding that a promise by an employer to pay backed by a letter of credit, which triggered constructive receipt to the employee) was “receipt” for purposes of the 2½- month rule under Treas. Reg. Sec. 1.404(b)-1T.

²⁹ HR. Conf. Rep. 98- 861, 98th Cong., 2d Sess., 1160 (1984) (emphasis added).

³⁰ TAM 199923045 (6/14/99); PLR 200009013 (11/26/99) (SAR’s vested within one year of payment not deferred compensation; SAR’s vesting more than a year before the date of payment were deferred compensation.)

³¹ Id. See also, discussion in BNA Tax Management Portfolio 385-5th, at A-3 and A-4.

³² In the ruling, the IRS stated specifically that “...significant services are still required for payment in the last year because the payment is forfeitable if they [i.e., services] are not provided. Therefore these payments are not deferred compensation.” TAM 199923045, supra note 30.

binding on the IRS (other than with respect to the taxpayer receiving the private ruling), other taxpayers are left with the risk that the IRS could take a contrary public position at any time.

(ii) Whose Taxable Year? Some may try to argue that the change to Section 404(a)(5) was made to conform Section 404(a)(5) to the new rules set forth in Section 83 by the 1969 Act concerning the payment of non-cash property to service providers. The Section 83 statutory language specifically stated that the deduction by the service recipient was allowed only in the taxable year of the payor “in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.”³³

However, as noted above, the language of Section 404(a)(5) is dramatically different from the precise and draconian language of Section 83(h). If Congress intended to defer the employer’s deduction to its taxable year in which or with which the employee’s taxable year ends, it would have used language identical to that of Section 83(h).

The vagueness³⁴ of Section 404(a)(5) contrasts sharply with the painstakingly precise anti-taxpayer WIW Rule formulation used in the contemporaneously enacted Section 83(h). Although the legislative history does not offer a reason for the difference, it is reasonable to conclude that a non-identical rule was intended—otherwise, identical language undoubtedly would have been used. Thus, the normal and logical interpretation of the actual statutory language should be used, which would eliminate the deferral problems noted at the beginning of this report.³⁵

³³ Section 83(h).

³⁴ The 1969 Act permitted another ambiguity to creep in: namely, the pre-1969 Section 404(a)(5) had referred to the deductibility of “such” contribution or compensation, using both terms. For reasons completely unexplained in the legislative history of the 1969 Act, the 1969 Act language (which continues to this day, with the addition in 1987 of language on payment of vacation accruals) referred only to the deductibility of “the contribution” and did not contain the word “compensation”. This led some commentators to say that the Section 404(a)(5) rule applied only to contributions to trusts, not to payment of normal deferred compensation. Some practitioners presumably took the position that this meant normal accounting rules applied to the deductibility of such payments, but at least one court looking at the issue (while rejecting the argument that new Section 404(a)(5) applied only to trust contributions), noted that if deferred compensation was not deductible under Section 404(a)(5) it would be deductible nowhere. Albertson’s Inc. v. Commissioner, 95 T.C. 415 (10/9/1990) (regarding a 1983 taxable year of the employer). The court in Albertson’s held that, therefore, the word “contribution” in Section 404(a)(5) also implicitly included payments of compensation when and if made, not just contributions to a trust, and, thus, that it governed non-trust deferred compensation plans. Likewise, certain private letter rulings contained opaque rulings indicating there might be a distinction, since they appeared to permit a deduction “upon paying or making available” a cash payment to the employee (with no reference to the taxable year limitation), see PLRs 199910002 (3/15/99) and 199912002 (3/29/99). Compare, however, PLRs 199901006 (9/28/98) and 199901013 (9/30/98), which were issued almost at the same time and use different language by simply repeating the words of the statute with its opaque reference to “taxable year”, but, significantly, also not using the WIW formulation in the Treasury Regulations. See also Schnee and McKinney, supra, note 12. In this context, it is worth noting that, under the Supreme Court case of Williams Co. v. Commissioner, 429 U.S. 569 (1977), payment by a note issued by the employer is not a “payment” for this purpose (or for any purpose under Section 404), although under some cases it may be a valid payment for analogous provisions in Section 267. In contrast, a payment in the form of a third-party note, even if guaranteed by the employer or its parent, appears to be a valid “payment” for this purpose. PLR 7852116 (9/28/78).

³⁵ In 1987, a final sentence was added to Section 404(a)(5) providing that vacation pay accruals were to be viewed as a plan of deferred compensation but that the deduction with respect to them was to be in the year “paid” rather than in the year included by the employee. The Conference Report describing this provision stated:

Unfortunately, none of the cases³⁶ or rulings³⁷ decided under Treasury Regulation Section 1.404(a)-12(b) have discussed the disparity between the language of the statute and the regulation, or any rationale for the divergence. Importantly, although the sparse case law follows Treasury Regulation Section 1.404(a)-12(b)(1),³⁸ none of the decisions have indicated that the Treasury must maintain the WIW Rule-interpretation of Section 404(a)(5) implicit in such regulations as opposed to using another formula.

III. Policy Reasons Supporting Committee's Position

(i) The Committee believes that a published clarification of the scope of “plan deferring the receipt of deferred compensation” is long overdue, and is needed in light of the

The conference agreement provides that vacation pay earned during any taxable year, but not paid to employees on or before the date that is 2½ months after the end of the taxable year, is deductible for the taxable year of the employer in which it is paid to employees. This provision is an exception to the general rule for deferred compensation and defined benefits pursuant to which an employer is allowed a deduction for the taxable year of the employer in which ends the taxable year of the employee in which the compensation or benefit is includible in gross income.

H. Conf. Rept. 100-495, 100th Cong., 1st Sess., 920 (1987), 1987-3 C.B. 193, 201. Although this language indicates that Congress had internalized the WIW Rule of the 1978 final Section 404(a)(5) Regulations, it is not an accurate summary of the existing statutory language. Subsequent commentary in the legislative history of later-passed legislation is generally not determinative of the intent of a previously enacted statute, and should particularly not be so here given the time gap between 1969 and 1987 and the presumed shift in staff and relevant congressional personnel during that period. H. Conf. Rept. 100-495, 100th Cong., 1st Sess., 920 (1987), 1987-3 C.B. 193, 201 (emphasis added), referring to Section 10201(b)(3) of the Revenue Act of 1987, P.L. 100-203. See Sullivan v. Finkelstein, 496 U.S. 617, 631 (Scalia, J., concurring in part); Mackey v. Lanier Collection Agency & Serv., 486 U.S. 825, 840 (1988), quoting United States v. Price, 361 U.S. 304, 313 (1960); United States v. Price, supra note 35. Of course, if a subsequent statute declares the proper interpretation of a previous statute, the later enacted statute to that extent may be said to interpret or perhaps actually override a prior statute; however, there is no evidence that the Revenue Act of 1987 had any such intention; the language of the Conference Report does not appear in the enacted statute and is descriptive only. See Red Lion Broadcasting Co. v. FCC, 395 U.S. 367, 380-81 (noting that “subsequent legislating declaring the intent of an earlier statute is entitled to great weight in statutory construction), cf. South Carolina v. Regan, 465 U.S. 367, 379, n. 17 (1984) (a “mere statement in a conference report. . . is obviously less weighty...Congress has not proceeded formally through the legislative process.” (emphasis added)) and Consumer Product Safety Commission v. GTE Sylvania, 447 U.S. 102, 118, n. 13 (1980)(dismissing statements on previously enacted law made in a conference report on an amendment to that law made four years after the law’s original enactment). See also generally CRS Report for Congress 97-589, Statutory Interpretation: General Principles and Recent Trends, at 44-48 (updated Aug. 31, 2008).

³⁶ See, e.g., Albertsons Inc. v. Commissioner, supra note 13; Weaver v. Commissioner, 121 T.C. 273 (2003); Truck Equipment Corp v. Commissioner, 98 T.C. 141 (1992); Avon Products v. Commissioner, 97 F.3rd 1435 (Fed Cir. 1996), vacating and remanding 76 AFTR, 95-2 UST.C. P50,462 (Ct. Fed. Cl. 1995).

³⁷ See, e.g., Rev. Rul. 88-68, 1988-2 C.B. 117; but see PLRs 199901006, supra note 34, 199901013, supra note 34, 199910002, supra note 34, and 199912002, supra note 34; see also Shnee & McKinney, supra note 12, and Brisendine, Veal & Wilson, 385-4th T.M., Deferred Compensation Arrangements.

³⁸ See, e.g., Albertsons Inc. v. Commissioner, supra note 13, Weaver v. Commissioner, supra note 36, Truck Equipment Corp v. Commissioner, supra note 36, and Avon Products v. Commissioner, supra note 36.

increasing importance and size of multi-year payment plans, such as SAR and phantom stock plans.

(ii) The Committee also believes there is a strong policy reason for adoption of its recommendation that the current Section 404(a)(5) timing regulations be amended to adopt a specific-date rule. As adverted to above and as set forth in detail through examples contained in the Annex to this report, the current rule is unfair to taxpayers because it imposes a procrustean tax accounting rule that does not match the economic facts. It also is counterintuitive from a business standpoint and under normal accounting methods so as to create a trap for the unwary.

Although opponents may urge uniform interpretation of Section 83 and Section 404(a)(5), such an argument, though facially appealing, lacks force. Because vesting causes immediate inclusion under Section 83, but not under the rules of deferred compensation, many of the problems noted above with respect to the WIW Rule do not occur under Section 83. Property that has vested in prior years has already been included in income (and deducted) in full (not short) taxable years of the employer; thus, so long as the employer is on a calendar taxable year, no deferral is required under Section 83(h). In contrast, if property is simply granted upon a change of control and vests upon grant (i.e., on the change of control), under Treasury Regulation Section 1.83-6(a)(3), the employer may use its normal method of tax accounting and is not bound by the WIW Rule of Section 83(h).³⁹

Only if property has not yet vested, but vesting accelerates on the closing of a transaction, does the Section 83(h) WIW Rule have any effect. Indeed, the very situation under Section 83 that would trigger application of the Section 83 WIW Rule—i.e., the lapsing of a substantial risk of forfeiture on a change of control—would be the exact case in which, if the property delivered were simply cash, Section 404(a)(5) would not apply, since the arrangement would not constitute a “plan deferring the receipt of compensation.” In contrast, the very place that the WIW Rule under Section 404(a)(5) would apply—i.e., the prior lapse of a substantial risk of forfeiture, followed a couple of years later by a payment at a change of control—would be the exact situation in which the Section 83(h) WIW Rule would not apply.

In other words, given the substantive differences between the inclusion rules of Section 83 and the definition of “plan of deferred compensation” that triggers Section 404(a)(5) application, uniformity of deduction timing as between the two sections is not only impossible to achieve, but is reduced, not enhanced, by extension of the WIW Rule to Section 404(a)(5). Whether or not the drafters of the 1969 Act deliberately chose not to include a statutory WIW Rule in Section 404(a)(5), these differences in the statutes certainly provide a policy argument against artificially grafting the WIW Rule onto Section 404(a)(5) solely for the sake of “uniformity” vis-a-vis Section 83.

Significantly, and as noted above in connection with the Committee’s second alternate proposal, Section 267, which attempts to tie payor’s deduction with payee’s inclusion, uses an

³⁹ Treas. Reg. Sec. 1.83-6(a)(3).

“exact day” method that does not turn on taxable years.⁴⁰ Under that method, the fact that a mid-year closing creates a short payor taxable year is irrelevant: so long as the payment occurs in the short year, sufficient “matching” occurs for purposes of Section 267, and the payor is allowed a deduction in the earlier, short, taxable year.⁴¹

IV. Conclusion

The Treasury is free to change these regulations on policy grounds as well as pursuant to normal statutory interpretation. The Committee urges that the Treasury do so in accordance with either of the proposals outlined earlier in this report.

⁴⁰ See Section 267(a)(2) (“any deduction [of expense or interest] allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to which the payment is made....”) (Emphasis added.)

⁴¹ See discussion in Schnee and McKinney, supra note 12, at 334.