

IRS Counsel Memo is Reminder That Employers May Not Currently Deduct Contributions of Their Own Debt Securities

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AUTHORS: Mark Carolan, Elizabeth Dold, Allison Itami, David Levine, Louis Mazawey

The 2018 tax filing deadline for employer “grace period” contributions to their pension plans is coming up on Friday, September 13, 2019. That is the last business day for such contributions to count for deduction purposes for 2018 (Code sec. 404(a)(6)) as well as for minimum funding purposes (Code sec. 430(j)(1)) for employers/plans that use the calendar year.

In light of the impending tax deadline, it is not particularly surprising to see that IRS has publicly released a memorandum (Chief Counsel Memo 201935011, rel. Aug. 30) providing “general legal advice” on the subject to IRS attorneys. We summarize key points in the IRS memo below – and add some others for employers to consider.

Background

Code section 404(a) generally provides that contributions to a pension trust are deductible “in the taxable year when paid,” subject to certain limitations. More than 40 years ago, the U.S. Supreme Court ruled that an employer could not currently deduct the value of a fully secured promissory note contributed to its plan because “the note ... is still only his promise to pay” and does not constitute “an outlay of cash or other property.” *Don E. Williams Co. v. Comm’r*, 429 U.S. 569 (1977). The Court said that the Code required an employer to pay out cash or its equivalent by the end of the grace period, *i.e.*, “an objective outlay-of-assets” test, for an amount to be deductible.

The IRS Memo

The IRS Memo provides considerable guidance on the facts and circumstances IRS auditors should consider in this area, in response to positions employers have taken. In particular, the IRS explains –

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- An employer's contribution of its own promissory note is not deductible as an actual payment "regardless of whether the note is secured or transferable."
- This same "no-deduction" principle applies if the employer's debt is publicly traded or if the debt is issued by a member of the plan sponsor's "controlled group."

The Memorandum also provides guidance on the impact of various restrictions or conditions on claims that contributed property is deductible. (This is the second part of the "outlay-of-assets" test.) For example –

- The plan's inability to access the asset – such as if the security is held in escrow, or is first available to creditors of the employer, or is otherwise restricted without prior approval of the employer – is a negative factor.
- The employer's ability to repurchase the property for a fixed number of years, or at the employer's discretion, will be a negative factor – even if the purchase price is independently determined.
- The plan's ability to "put" the security back to the employer – including circumstances giving the employer the ability to control the plan's transfer of the asset – must be evaluated, as should any prohibitions on the trustee's ability to transfer or pledge the security.

Observations

Employers faced with significant cash needs, and/or a material level of plan underfunding, should consider possible opportunities to use employer stock or other assets to alleviate the situation. However, the new IRS Counsel Memo makes it clear that IRS continues to follow the *Don Williams* decision and indicates that IRS agents should carefully scrutinize employer claims of tax deductions for funding of their plans involving debt or other property.

Plan sponsors should keep in mind that, even though a current deduction is not available, an employer that has contributed its own debt securities will be able to deduct payments it makes on securities held by the plan as and when they are made. In addition, at least one private letter ruling indicates the employer should get a deduction when and if the plan sells the debt to an unrelated third party. See PLR 201249018 (involving contributions to a "voluntary employees' beneficiary association" described in Code section 501(c)(9)).

In addition to the tax risks, employers should keep in mind that –

- the fiduciary responsibility and prohibited transaction rules of ERISA allow in-kind contributions of employer securities only in limited circumstances (in general, the employer securities must constitute "stock" or "marketable obligations" (ERISA sec. 407(d)) and may not exceed 10% of all plan assets (ERISA sec. 407(a)(2)) in the aggregate), and
- once a plan properly acquires ownership of qualifying employer securities, special fiduciary care should be taken to manage the holdings independently of the employer's interests.

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Groom has worked with many clients to obtain IRS and DOL rulings on non-cash contributions to their pension and welfare plans consistent with applicable IRS and DOL guidance. Please contact your Groom attorney to discuss possible opportunities that may be available to your company.

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