OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel (Employee Benefits and Exempt Organizations) CC:EBEO

SUBJECT:

This Field Service Advice is in response to your memorandum dated October 5, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =

Date 1 =

Date 2 =

Date 3 =

Year A =

Year B =

Trust =

Taxpayer's Representative =

ISSUE:

Whether penalties provided under section 6662 of the Internal Revenue Code should be asserted with respect to Taxpayer's claiming of deductions for contributions to the Trust.

CONCLUSION:

Penalties should not be asserted as described in your draft memorandum, because none of the grounds that you describe should be asserted as a basis for the disallowance of Taxpayer's deductions. In connection with a section 419 theory, however, it may be appropriate to assert the substantial understatement penalty with respect to Year A.

FACTS, LAW, AND ANALYSIS:

On October 8, 1999, we received your October 5 memorandum requesting review of a draft memorandum that you propose to send to the District Director concerning a pending examination of Taxpayer. You characterized your request as being for NSAR (nondocketed significant advice review). As indicated on October 12 by the IT&A Branch of Domestic Field Service, the NSAR procedures do not apply to a review of this type, and we are treating your inquiry as a request for Field Service Advice.

In the draft memorandum, you indicate that the Examination Division issued to Taxpayer a Form 5701, dated Date 1, proposing disallowance of Taxpayer's accelerated deductions for vacation pay for Year A through Year B. Of the various grounds for disallowance described in the Form 5701, you discuss three: failure of the all events test, lack of economic substance, and a grantor trust theory. On the basis of these three grounds, your draft memorandum recommends the assertion of penalties against Taxpayer. Specifically, you recommend assertion of penalties for negligence and disregard of rules and regulations for all four years. You also recommend assertion of the substantial understatement penalty for Year A (but not for the other years, in view of the amounts involved).

You requested expedited review because of an agreement between Examination and Taxpayer to complete the examination by Date 2, and the need to provide Taxpayer with an opportunity to respond to the assertion of penalties. While the short time frame and the length of your draft memorandum preclude a detailed response, please be assured that we have carefully considered all the points that you have raised. We will be happy to work through these issues more

thoroughly with you but, based on your stated time frame, we wanted to share our initial concerns with you quickly.

For the reasons that follow, we conclude that none of the grounds you describe should be asserted as a basis for disallowance. Rather, the correct ground for disallowance of Taxpayer's deductions is that, because the Trust is a welfare benefit fund under section 419 of the Code, contributions to the Trust are deductible no earlier than the year in which they are paid to the Trust. See section 419(a). Although we have not seen a copy of the Form 5701, we assume this ground is also described in that document.

All events test. You have suggested that the all events test is not satisfied with respect to Taxpayer's liability to make contributions to the Trust. Either the Trust is respected for tax purposes or it is not. If the Trust is respected, there is no accrual issue because the regulations under section 419 treat the requirements of section 461(a) as having been satisfied to the extent that the otherwise applicable section 419 requirements are met. See §1.419-1T, Q&A-10(d). The real problem (for the deduction) is simply that the 419 requirements are not met, as noted above. If the Trust is not respected, the issue is not accrual of the obligation to contribute to the trust but rather accrual of Taxpayer's underlying obligation to its employees to pay them the vacation pay that they have earned. As we understand it, that accrual is not in dispute.

Economic substance. You have suggested that the Trust and related contributions lacked economic substance. A representative of this office previously advised your office in a telephone conversation that an economic substance argument should not be made in this case. At that time we were evaluating whether such an argument should be asserted in vacation pay cases involving letters of credit. We explained to the drafter of your memorandum that, whatever the outcome of that evaluation, an economic substance argument should not be made here. We have since concluded that an economic substance argument should be asserted in letter-of-credit cases, see Rev. Proc. 99-26, 1999-24 I.R.B. 38, but remain of the view that it should not be made here for reasons discussed below. You have also suggested that the Trust was not validly adopted because there was no board resolution authorizing Taxpayer's assistant treasurer to enter into the trust agreement when he signed it. However, we understand that there was a board resolution the following year, retroactively ratifying his action. We recommend against challenging the retroactivity of the ratification, in view of his apparent (if not actual) authority at the time of signing and, more generally, a policy preference under ERISA for respecting the validity of a trust where protection of benefits is involved.

Grantor trust theory. You have suggested that the Trust is a grantor trust under various provisions of subpart E of chapter J. However, the authority that you cite either predates the enactment of sections 419 and 419A or does not involve welfare benefit funds. As a general matter, the rules of sections 419 and 419A of the Code preclude a nonexempt trust that is a welfare benefit fund, within the meaning of section 419(e), from being treated as a grantor trust, because there are fundamental inconsistencies between the tax consequences under those sections and treatment of the employer as the owner of such a trust under subpart E.

Because none of these three grounds should be asserted as a basis for disallowance of Taxpayer's accelerated deductions, none of them provides a basis for asserting any penalties. However, in light of the section 419 theory for disallowing the deductions, it may be appropriate to assert the substantial understatement penalty for Year A on the basis that the accelerated deduction is a tax shelter item. The Trust is a tax shelter within the meaning of section 6662(d)(2)(C)(iii) unless Taxpayer can demonstrate that its principal purpose was something other than to accelerate a deduction. If it is a tax shelter, the substantial understatement penalty would apply unless Taxpayer reasonably believed that its treatment of the deduction was more likely than not the proper treatment. Under the regulations applicable to that year, Taxpayer is permitted to satisfy the "more likely than not standard" either on the basis of its own analysis or through good faith reliance on the opinion of a professional tax adviser. However, Taxpayer's Representative's opinion letter will not suffice for this purpose, because it did not even consider the "more likely than not standard." Therefore, Taxpayer would have to demonstrate that it met the standard on the basis of its own analysis.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

In this regard, please note that the practice whereby an employer pays various employee benefits through its regular payroll system as an agent of an employee benefit plan and obtains reimbursement from the associated trust is neither uncommon nor, in our opinion, improper from a tax perspective. We have reviewed the Trust, and it appears to be a typical ERISA trust. Moreover, Taxpayer actually parted with significant assets when it made contributions to the Trust and could not take them out of the Trust except for payment of benefits to employees, which is what the payments back to itself as agent actually were.

Although the subject is not addressed in your draft memorandum, we have considered whether penalties would be appropriate in light of the section 419

theory for disallowing the deductions. We have reviewed the opinion letter dated Date 3, that Taxpayer received from Taxpayer's Representative, including the arguments based on the committee reports accompanying the repeal of section 463 in 1987. Although we disagree with the letter's conclusion, we believe that Taxpayer had substantial authority for its return position, relieving it of liability for penalties based on negligence or disregard of rules and regulations. However, it may be appropriate to assert the substantial understatement penalty for Year A on the basis that the accelerated deduction is a tax shelter item as indicated above; Taxpayer may be unable to demonstrate that it met the "more likely than not standard" on the basis of its own analysis.

If you have any questions concerning this memorandum or would like to discuss the issues further, please feel free to call us at (202) 622-6060.

MARY E. OPPENHEIMER
Assistant Chief Counsel

By: _____
MARK SCHWIMMER
Chief, Branch 4
Office of the Associate Chief Counsel
(Employee Benefits and Exempt Organizations)