INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No. TAM-119181-99/CC:DOM:IT&A:B5

District Director June 12, 2000
District

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference: March 17, 2000

LEGEND:

Taxpayer =
$x =
$y =
z% =

ISSUE:

1) Do Taxpayer's payments to participating employees pursuant to a "Promissory Note and Pledge Agreement" and a "Bonus Agreement" constitute compensation for future services or the proceeds of a bona fide loan?

2) If such payments constitute compensation for future services, is Taxpayer entitled to currently deduct such payments in the year paid under § 162 of the Internal Revenue Code?

CONCLUSION:

1) The payments at issue constitute compensation to participating employees for future services.

2) Taxpayer incurs the amounts at issue as participating employees perform services over the five year term of the Note and Bonus Agreement and Taxpayer may currently deduct under §162 the amount incurred in each year.

FACTS:

Taxpayer is engaged in the securities business and uses an accrual method of accounting for purposes of computing its income for federal income tax purposes. Taxpayer's common stock is not publicly traded.

This case involves a series of interrelated transactions between Taxpayer and certain new employees (stockbrokers). As a means of recruiting employees, Taxpayer offers an arrangement under which the new employee ("participating employee") receives certain payments ("up-front payments"). At the time the up-front payments are made Taxpayer and the participating employee simultaneously enter into two contracts. The first document is entitled "Bonus Agreement," the second is entitled "Promissory Notes and Pledge Agreement" ("Note").

Although the Note's specific dollar amount and interest rate vary from participating employee to participating employee, the overall structure of the transaction is the same for each participating employee. For example, a typical participating employee might receive an up-front payment of $x. Under the Note, this principal sum ($x) is repayable with interest at z% in five annual installments of $y due on the last day of August each year. Taxpayer will forgive the entire remaining unpaid principal and accrued interest upon the death or disability of the participating employee while employed by Taxpayer or upon termination of employment with Taxpayer other than for cause. At the option of Taxpayer, any unpaid principal and interest will become immediately due and payable in the event a participating employee defaults on a payment of an installment when due. If any such default is not cured within five days, Taxpayer has the right to withhold from any amounts payable to a participating employee as compensation or otherwise, the amount of any payments due under the Note and to apply the withheld amounts to the remaining amounts due under the Note. Taxpayer takes a security interest in all Taxpayer common stock owned or acquired by a participating employee during the term of the Note as collateral for the Note.

Under the Bonus Agreement Taxpayer agrees to pay annual bonuses (plus interest at the rate of z%) to a participating employee in five annual installments of $y (based on the above example) on the last day of August each year. The Bonus Agreement provides that a participating employee "acknowledges the contemporaneous execution of a Promissory Note in the amount of $x payable to" Taxpayer and that "all bonus payments made pursuant to this Agreement shall be applied to the payment of the Promissory Note until paid in full." The Bonus Agreement states that the participating employee "understands that bonuses paid under this Agreement shall not be considered 'recognized compensation'" and shall be disregarded for purposes of Taxpayer's employee benefit plans, including, but not limited to, the Taxpayer Employee Stock Ownership Trust and Profit Sharing Plans.

LAW:

Section 61 provides, in part, that gross income includes compensation for services. The proceeds of a bona fide loan are not includible in gross income. See James v. United States, 366 U.S. 213, 219 (1961).

Section 83(a) generally provides that the excess (if any) of the fair market value of property transferred in connection with the performance of services over the amount paid (if any) for the property is includible in the gross income of the person who performed the services for the first taxable year in which the property becomes transferable or is not subject to a substantial risk of forfeiture.

Section 1.83-3(e) of the Income Tax Regulations generally provides that for purposes of § 83 the term "property" includes real and personal property other than money or an unfunded and unsecured promise to pay money or property in the future. Property also includes a beneficial interest in assets (including money) transferred or set aside from claims of the transferor's creditors, for example, in a trust or escrow account.

Under the economic benefit doctrine, an employee has currently includible income from an economic or financial benefit received as compensation, though not in cash form. Economic benefit applies when assets are unconditionally and irrevocably paid into a fund or trust to be used for the employee's sole benefit. Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd per curiam, 194 F. 2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174, Situation 4. In Rev. Rul. 72-25, 1972-1 C.B. 127, and Rev. Rul. 68-99, 1968-1 C.B. 193, an employee does not receive income as a result of the employer's purchase of an insurance contract to provide a source of funds for deferred compensation because the insurance contract is the employer's asset, subject to claims of the employer's creditors.

Section 162(a) generally allows as a deduction “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." To qualify as an allowable deduction under § 162(a), an item must (1) be paid or incurred during the taxable year; (2) be for carrying on any trade or business; (3) be an expense; (4) be a necessary expense; and (5) be an ordinary expense. Commissioner v. Lincoln Sav. & Loan Ass'n., 403 U.S. 345, 352 (1971). The term "ordinary" has been seen as a way to "clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset." Commissioner v. Tellier, 383 U.S. 687, 689-690 (1966). Under § 1.162-7(a) amounts paid or incurred in carrying on any trade or business include salaries and other compensation for personal services actually rendered.

Section 263 generally provides that no deduction shall be allowed for the cost of permanent improvements or betterments made to increase the value of any property. Section 1.263(a)-2(a) clarifies that § 263 requires the capitalization of costs incurred to acquire property having a useful life substantially beyond the close of the taxable year. An expenditure is capital if it creates or enhances a separate and distinct asset or if the expenditure produces a significant long-term benefit. See INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992); Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345 (1971).

Section 404(a) provides the general deduction timing rules applicable to a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan or arrangement for deferring compensation, regardless of the Code section under which the amounts might otherwise be deductible. Pursuant to § 404(a)(5), contributions or compensation deferred under a nonqualified plan or arrangement are deductible in the taxable year in which an amount attributable to the contribution are includible in the gross income of the employees participating in the plan, but in the case of a plan in which more than one employee participates, only if separate accounts are maintained for each employee. See also § 1.404(a)-12(b)(3).

Section 461 governs the determination of when a liability is incurred and taken into account. Section 461(a) generally provides that the amount of any deduction or credit shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income. For accrual method taxpayers, a liability is incurred and taken into account in the year in which (1) the liability is "fixed" -- that is generally the year in which the liability becomes an enforceable obligation; and (2) the amount of the liability can be determined with reasonable accuracy. In addition, § 461(h) specifies that a liability is not incurred any earlier than the year in which economic performance occurs.

Section 461(h)(2)(A)(i) provides that, if the liability of the taxpayer arises out of the providing of services to the taxpayer by another person, economic performance occurs as that person provides the services.

Both the regulations under § 461and the preamble to the § 461(h) final Income Tax Regulations make clear that § 461 merely provides rules for determining when an item is incurred and that "[a]pplicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account." Section 1.461-1(a)(2); T.D. 8408, 1992-1 C.B. 155, 161.

ANALYSIS:

The first issue to be addressed is whether the up-front payments from Taxpayer to participating employees constitute compensation or loan proceeds. Taxpayer

asserts that these amounts are the proceeds of bona fide loans while the field argues that these amounts are compensation to the participating employees. For the reasons described below, the up-front payments are compensation to the participating employees and not the proceeds of bona fide loans. Further, under the economic performance rules of § 461(h) Taxpayer is treated as incurring the up-front payments as the participating employees provide services over the life of the Note and Bonus Agreement.

I Characterization of Payments.

In form, the transactions appear to be bona fide loans. The following factors are indicative of a bona fide loan: (1) the employee signs a promissory note; (2) the employee must make cash payments according to a specified repayment schedule; (3) interest is charged; and (4) there is security for the loan (Taxpayer stock held by the employee). Although the transactions appear to be, in form, bona fide loans, we conclude that, in substance, the up-front payments constitute compensation includible in gross income upon receipt.

We conclude that the purported loan lacks the indicia of bona fide indebtedness. First, we do not believe there is an unconditional and personal liability on the part of the "debtors" (participating employees). A loan from an employer to an employee is bona fide if there is an unconditional and personal obligation on the part of the employee to repay the loan. See, e.g., Kinzy v. United States, 1987-2 U.S.T.C.¶ 9520 (N.D. Ga. 1987); Gales v. Commissioner, T.C. Memo 1999-27, acq., A.O.D. 1999-011, 1999 AOD LEXIS 14; and George Blood Enterprises, Inc. v. Commissioner, T.C. Memo 1976-102. In the present case, unconditional and personal obligations to repay the loans are not present because the loans will be repaid with guaranteed "bonus payments" to be made by Taxpayer, which precisely match the payments due under the loans. The employee will be required to repay a portion of the up-front payment only if the employee leaves Taxpayer's employ before the end of the required period of service. Provided the employee provides all of the contracted services, he or she will not be required to repay any portion of the up-front payment. This case is thus distinguishable from other cases in which the debtor has personal liability because the income stream securing the debt may be insufficient to pay the debt. For example, in Gales, at the time the insurance salesperson borrowed funds from the employer, there was uncertainty as to the amount of insurance commissions to be received in the future. Thus, it was not known whether the commissions would be sufficient to satisfy the employee's obligation to the employer, and the employee was personally responsible for repayment of any shortfall.

Second, the purported loan does not require cash payments in accordance with a specific repayment schedule. It is well-established that in the case of a loan, the debtor must satisfy the repayment obligation by making a monetary or cash payment pursuant to the agreement. Beaver v. Commissioner, 55 T.C. 85 (1970). In the present

case, despite the form of the transaction, the employee's obligation is satisfied in substance by the performance of services over five years, rather than by a cash payment. For each year services are performed, one-fifth of the debt is forgiven. Thus, there is a forgiveness of the debt, rather than a payment of the debt by cash.

In support of its position, Taxpayer argues that the participating employees make cash payments of the loan by applying the bonus payments towards the debt. This argument presupposes that (1) the bonus payments constitute gross income at the time the bonuses are "paid" and (2) the application of the bonus payments towards the debt involves an actual payment (cash expenditure) for which an interest deduction would be allowed, assuming that deduction of interest would otherwise be proper.

The tax treatment of the individual employees is not at issue and is not intended to be resolved in this technical advice memorandum. Nonetheless, understanding our conclusion that the only payment having any tax effect (e.g., a compensatory payment) was the up-front payment rather than the purported bonuses necessarily requires examining the substantive tax effect to be accorded to each. Based on a thorough examination of all surrounding facts and circumstances, we believe that only the up-front payment has any tax effect, and that by contrast the bonus payments should not be treated as compensatory payments to the employees. Accordingly, we must reject Taxpayer's contention that the annual offset of the "bonuses" against a portion of the "loan" represents the employee's periodic receipt of income and the simultaneous repayment of loan principal and (potentially) deductible interest. Instead, we have concluded that the up-front payment is in fact the only relevant compensatory payment by Taxpayer, with the Taxpayer's deductibility of that compensation determined under §§ 162 and 461 (discussed in Section II, infra).

First, the periodic bonus payments do not constitute gross income to the employees. Receipt of the bonus payments does not create any accession to wealth over which the employee has dominion and control. The employee lacks dominion and control over the bonus payments because under the Bonus Agreement the bonus payments must be immediately applied towards repayment of the loan. Further, each loan payment and each corresponding bonus payment match both as to amount and as to timing.

In addition, the repayment of the purported loans would not give rise to interest deductions because, in substance, there are no payments (cash expenditure) by the employees. A cash expenditure is not present because the "lender" (Taxpayer) provides the funds with which the "borrowers" make an immediate repayment on the loans. The courts have disallowed interest deductions in similar circumstances involving an advance by a lender to pay interest on a loan. Davison v. Commissioner, 141 F.3d 403 (2d Cir. 1998); Battelstein v. Commissioner, 631 F.2d 1182 (5th Cir. 1980).

As stated above, the employee receives a bonus payment and must immediately use this money to make payment on the loan. This may be accomplished either by an actual exchange of checks or, without a check swap, by offsetting the employee's obligation to Taxpayer against Taxpayer's obligation to the employee. This circular flow of funds between the parties should be disregarded for tax purposes, because it lacks a business purpose and economic substance and appears to be motivated solely by tax avoidance considerations, rather than by any independent nontax purpose. See generally Bail Bonds by Marvin Nelson, Inc. v. Commissioner, 820 F.2d 1543 (9th Cir. 1987); Rev. Rul. 86-106, 1986-2 C.B. 28; and Rev. Rul. 82-94, 1982-1 C.B. 31.

We further note that if the employee leaves before the end of the required period of service, the employee generally will be required to pay the balance due on the loan. This repayment obligation appears to be more in the nature of liquidated damages for breach of the employment contract rather than a payment of principal and interest. See, e.g., Rev. Rul. 67-48, 1967-1 C.B. 50. This obligation is a conditional obligation that arises only upon the occurrence of an event subsequent to the receipt of the up-front payment. Such a conditional obligation is not sufficient to characterize the transaction as a loan.

Our conclusion that the up-front payments are advance payments for services and not loan proceeds also is not affected by either §83 or § 404 . Section 1.83-3(e) excludes from the definition of "property," money or an unfunded and unsecured promise to pay money or property in the future. There is no indication that Taxpayer has transferred or set amounts aside from claims of its creditors or has unconditionally or irrevocably placed assets in a fund or trust to be used for the participants' sole benefit. Therefore, § 83 does not apply to the arrangement. Further, the arrangement is not a stock bonus, pension, profit-sharing, or annuity plan and the amounts are not paid or accrued on account of any employee under a plan or arrangement for deferring compensation. Thus, the amounts are not deductible under § 404(a)(5).

II Timing of Deduction.

The final issue to be considered in this request for technical advice is the timing of Taxpayer's deduction for the up-front payments. This requires analyzing the all-events test and the economic performance requirement of § 461 to determine when the up-front payments are incurred for federal income tax purposes, and §§ 162 and 263 to determine whether the up-front payments that have been incurred may be deducted as ordinary and necessary business expenses.

First, the Taxpayer is not entitled to accrue the entire amount of the up-front payments in the year paid to individual employees. Section 1.461-1(a)(2) of the Regulations provides that under an accrual method of accounting, a liability is incurred and generally is taken into account for federal income tax purposes in the taxable year in which all the events have occurred that establish the fact of the liability, the amount

of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Under the facts at issue, the all-events test (i.e., the fact and amount of liability) is satisfied upon the Taxpayer's payment to an individual employee. As of that date, the Taxpayer's liability to the employee is fixed and the amount of that liability is reasonably determinable, notwithstanding that later events, such as the employee's resignation, may alter the ultimate amount of the liability.

Although the all-events test is satisfied when the up-front payment is made, the third requirement – economic performance – is not. Section 461(h)(2)(A)(i) of the Code provides that with respect to a liability of a taxpayer arising out of the providing of services to the taxpayer by another person, economic performance occurs as the person provides the services. See also § 1.461-4(d)(2) of the Regulations. Because we have determined that, in substance, the up-front payment is an advance payment for services to be provided to the Taxpayer over a multiple year period, the payment is incurred for federal tax purposes only as and to the extent the related services are provided to the Taxpayer. Under the facts at issue, we believe the amount of the annual "bonuses" is the relevant measure for the amount of the up-front payment allocable to services performed during a particular year. Only this amount has been incurred under § 461.

Second, the up-front payments that are incurred in a given year are deductible as ordinary and necessary business expenses. Section 1.162-7(a) permits a current deduction for amounts paid or incurred by a taxpayer for salaries and other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. For the reasons discussed previously, the up-front payments represent compensation paid to Taxpayer's employees and as such are ordinary and necessary expenses of the Taxpayer's trade or business that are deductible under § 162 in the year incurred.

In summary, Taxpayer incurs the amounts at issue as participating employees perform services over the five year term of the Note and Bonus Agreement and Taxpayer may currently deduct under § 162 the amount incurred in each year. Taxpayer may not deduct the full amount of the up-front payments in the year of payment. Our conclusion that the up-front payments to the employees may not be deducted in full in the year of payment results from an application from the economic performance rules of § 461(h), and is not affected by § 263 or by the Supreme Court's decision in INDOPCO, supra.

CAVEAT(S):

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