APPEALS
TECHNICAL GUIDANCE
SETTLEMENT GUIDELINES

ISSUE: 401(K) ACCELERATED DEDUCTIONS

COORDINATOR: Munir I. Ebeid

TELEPHONE NUMBER: (972)308-7493

UIL NO: 9300.01-1

FACTUAL/LEGAL ISSUE: Legal/Factual

APPROVED:

*/S/ Thomas C. Lillie*_____________________ ___Oct 01, 2004__
for DIRECTOR, TECHNICAL GUIDANCE DATE

*/S/ L.P. Mahler*_________________________ ___Oct 01, 2004__
DIRECTOR, TECHNICAL SERVICES DATE

EFFECTIVE DATE: ___Oct 01, 2004__

APPEALS SETTLEMENT GUIDELINES

DEDUCTION OF CONTRIBUTIONS TO I.R.C. 401(k) PLAN OR TO A DEFINED CONTRIBUTION PLAN AS MATCHING CONTRIBUTION UNDER I.R.C. 401(m) ATTRIBUTABLE TO COMPENSATION EARNED AFTER THE END OF THE TAX YEAR UNDER IRC 404 (a)(6)

ISSUE 1

Issue same as ASG dated 10/25/96

Whether contributions to a qualified cash or deferred arrangement within the meaning of I.R.C. § 401(k) or to a defined contribution plan as matching contributions within the meaning of I.R.C. § 401(m) are deductible by the employer for a specific taxable year, if those contributions are made during the grace period of such taxable year and are attributable to elective deferrals and matching contributions relating to compensation earned by plan participants after the end of such taxable year.

ISSUE 2

New Issue: Rev. Rul. 2002-46

Whether contributions made during the I.R.C. § 404(a)(6) grace period to a qualified cash or deferred arrangement within the meaning of I.R.C. § 401(k) or to a defined contribution plan as matching contributions within the meaning of I.R.C. § 401(m) are deductible by an employer for a taxable year, if the contributions are designated as satisfying a liability established before the end of that taxable year but attributable to compensation earned by plan participants after the end of that taxable year.

ISSUE 3

New Issue: Rev. Rul. 2002-46

Whether the change in the treatment of contributions from claiming a deduction in a taxable year for all amounts contributed during the § 404(a)(6) grace period to claiming a deduction in a taxable year only for amounts contributed during the grace period that are attributable to compensation earned during the taxable year is a change in accounting method to which I.R.C. §§ 446 and 481 apply.

Issue 4

New Issue: Rev. Rul. 2002-46

Whether the following components of the I.R.C. § 6662 accuracy-related penalty may apply:

- Negligence or Disregard of Rules or Regulations, or
- Substantial Understatement of Income Tax

Further, if the accuracy-related penalty otherwise applies, has the taxpayer established that there was reasonable cause and that the taxpayer acted in good faith, thereby precluding imposition of the penalty?

BACKGROUND

History of Rev. Rul 90-105 and Rev. Rul. 2002-46

Taxpayers sponsoring salary deferral plans as described in I.R.C. § 401(k) contribute and deduct elective deferrals, matching contributions and discretionary contributions made to their 401(k) plans based on the plan documents, employees' elective deferrals and I.R.C. § 404 and other applicable Code sections. Rev. Ruls. 90-105 and 2002-46 address anomalies unintended by Congress.

Rev. Rul. 76-28, 1976-1 C.B. 106, (January 1, 1976) held that an employer's payment to a qualified retirement plan after the close of the employer's taxable year to which section 404(a)(6) of the Internal Revenue Code applies shall be considered to be on account of the preceding taxable year (providing the plan was in existence in such year) if the plan treats the payment as it would treat a payment actually received on the last day of the employer's preceding taxable year, and the employer designates the payment in writing to the plan administrator or the trustee as a payment on account of its preceding taxable year or deducts the payment on its tax return on or before the due date of its return for such year, including extensions thereof.

Revenue Ruling 90-105, 1990-2, C.B. 69, held that contributions to a qualified cash or deferred arrangement under I.R.C. § 401(k) or a defined contribution plan as matching contributions under I.R.C. § 401(m) are not 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 holding applies regardless of whether § 404(a)(6) deems the contributions to have been paid on the last day of that taxable year, and regardless of whether the employer uses the cash or an accrual method of accounting.

In the application section, the revenue ruling stated that a taxpayer using a method of accounting inconsistent with the revenue ruling would be required to change its method of accounting. Procedures for timely effecting the change are set forth therein.

Rev. Rul. 90-105 concluded that grace period contributions attributable to elective deferrals and matching contributions based on compensation earned by plan participants after the end of the employer's tax year are not deductible since the contributions were:

- Not "on account of" the preceding tax year as described in Rev. Rul. 76-28,
- Not based on compensation for services rendered during the tax year, and
- Not based on a fixed liability, under I.R.C. section §461 (for a taxpayer using an accrual method of accounting).

On 9/5/95, Compliance issued a Coordinated Paper ("CIP") based on the transaction described in Rev. Rul. 90-105. Appeals issued the Appeals Settlement Guideline ("ASG") shortly thereafter, 10/25/96.

In response to concerns over the proliferation of tax shelter activity, the Service published Notice 2000-15, on 2/28/2000, putting taxpayers on notice that particular tax-avoidance transactions were considered "listed transactions" for purposes of Temporary Reg. §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2). The transaction described in Rev. Rul. 90-105 is the first transaction identified in Notice 2000-15 as a "listed transaction".

Some taxpayers attempted to distinguish their transaction from that described in Rev. Rul. 90-105 by making slight refinements including:

- Amending their plan prior to tax year-end to provide for a "minimum employer contribution" (MEC) to the plan.
- Adopting a Board Resolution, which determined a MEC prior to the end of the tax year.

Under this variation, the employer's promise of the MEC was fulfilled during the § 404(a)(6) grace period by employees' deferrals and the employer's matching contributions attributable to compensation earned during the grace period. Taxpayers have taken the position that they are entitled to deduct such contributions on the tax return for the preceding taxable year. Thus, taxpayers accelerate their deductions by claiming an additional deduction for the preceding tax year for contributions made during the I.R.C. § 404(a)(6) grace period, i.e., the period between the end of the taxable year and the due date as extended for filing the tax return for that year. These are referred to as "Grace Period Contributions".

Rev. Rul. 2002-46, 2002-29, I.R.B. 117, was issued to address modifications made to the transaction described in Revenue Ruling 90-105. Rev. Rul. 2002-46 concluded that, notwithstanding the MEC requirement based on a Board of Directors resolution, the factual discrepancies between the transaction described in Rev. Rul. 2002-46 and that described in Rev. Rul. 90-105 were not significant enough to change the holding. Further, it determined that the transaction is substantially similar to the transaction described in Rev. Rul. 90-105. Accordingly, the Rev. Rul. 2002-46 transaction is a tax avoidance transaction and is identified as a "listed transaction".

Specifically, Rev. Rul. 2002-46, concluded that:

- Contributions made during the § 404(a)(6) grace period to a qualified cash or deferred arrangement within the meaning of I.R.C. § 401(k) or to a defined contribution plan as matching contributions within the meaning of I.R.C. § 401(m) are not deductible by an employer for a taxable year, if the contributions are designated as satisfying a liability established before the end of that taxable year but are attributable to compensation earned and elective deferrals to be made by plan participants after the end of that taxable year.

- A change in a taxpayer's treatment of contributions to a method consistent with the ruling is a change in method of accounting to which I.R.C. §§ 446 and 481 apply.

On December 20, 2002, Appeals designated the transaction described in Rev. Rul. 2002-46, dealing with the accelerated deduction of contributions to section 401(k) plans, related changes of accounting method adjustments and penalties as an Appeals Coordinated Issue (ACI).

Compliance revised its 1995 Coordinated Issue Paper (CIP) in 2004 to address the transaction described in Rev. Rul. 2002-46 and the applicability of penalties under I.R.C. § 6662.

COMPLIANCE POSITION – ISSUES 1, 2, & 3

The Coordinated Issue Paper (CIP) approved in 1995 addresses the facts described in Rev. Rul. 90-105, 1990-2 C.B. 69, dealing with the accelerated deduction of contributions to section 401(k) plans. Rev. Rul. 2002-46, 2002-2 C.B. 117, addresses a situation, arising in many current examinations, which is substantially similar to that described in Rev. Rul. 90-105, and is described below.

FACTS

For purposes of discussion, the supplemental CIP provides the following scenario:

The taxpayer corporation has a plan with a qualified cash or deferred arrangement under section 401(k). The plan also provides for matching contributions in accordance with section 401(m). The corporate tax year-end is June 30th and the plan's year-end is December 31st.

The taxpayer amended the plan to provide for a Board of Directors' resolution specifying a minimum contribution for the plan year, to be allocated first toward elective deferrals and matching contributions, with any excess to be allocated to participants as of the end of the plan year, in proportion to compensation earned during the plan year.

Pursuant to this plan amendment, the Board of Directors adopted a resolution on June 15, 2001, setting a minimum contribution of $8,000,000 for the 2001 calendar plan year. By December 31, 2001 (the last day of the 2001 calendar plan year), the corporation had contributed $8,000,000 to the plan in accordance with the terms of the plan.

These amounts consisted of (1) $3,800,000 for elective deferrals and matching contributions attributable to compensation earned by plan participants before the end of taxable year ending June 30, 2001 (Pre-Year End Service Contributions), and (2) $4,200,000 for elective deferrals and matching contributions attributable to compensation earned by plan participants after the end of the taxable year ending June 30, 2001 (Post-Year End Service Contributions).

The taxpayer made each contribution attributable to compensation earned during each pay period contemporaneously with the issuance of wage payments for the pay period.

The corporation received an extension of time to March 15, 2002, to file the income tax return for its taxable year ending June 30, 2001 (2001 Taxable Year). On the income tax return for its 2001 Taxable Year, which was timely filed on March 1, 2002, the corporation claimed a deduction for the entire $8,000,000 for elective deferrals and matching contributions made to the plan during the 2001 calendar plan year, relating to both Pre-Year End Service Contributions and Post-Year End Service Contributions.

The total amount contributed and claimed by the taxpayer as a deduction did not exceed 15 percent of the total compensation otherwise paid or accrued during its 2001 tax year to participants under the plan (and thus did not exceed the applicable percentage limitation for that year under section 404(a)(3)(A)(i)).

LAW

Section 404(a) provides in relevant part that if contributions are paid to a profit-sharing or stock bonus plan and are otherwise deductible under chapter 1 of the Code, those contributions are deductible under section 404 (subject to certain limitations) in the taxable year of the employer when paid, and are not deductible under any other section of chapter 1 of the Code.

Section 404(a)(6) provides in relevant part that, for this purpose, "a taxpayer shall be deemed to have made a payment on the last day of the preceding taxable year if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof)."

Section 1.404(a)-1(b) of the Income Tax Regulations provides that, in order to be deductible under section 404(a), in the case of contributions that are otherwise deductible under section 162 or 212, the contributions 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. A contribution which is otherwise deductible under section 162 or 212 is deductible under section 404(a) if it is paid or incurred for purposes of those sections, in addition to satisfying the other requirements for deductibility under those sections.

Section 461(a) and section 1.461-1(a)(2) of the regulations together provide that an accrual method taxpayer should deduct expenses for the taxable year in which all the events have occurred which determine the fact of liability, the amount thereof can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. No accrual shall be made in any case in which all of the events have not occurred which fix the liability, nor if the amount of the liability cannot be determined with reasonable accuracy, nor if economic performance has not occurred with respect to the liability. (Treasury Regulations Section 1.461-1(a)(2).)

DISCUSSION

Rev. Rul. 90-105, 1990-2 C.B. 69, applies section 404(a)(6), as interpreted by Rev. Rul. 76-28, 1976-1 C.B. 106, to a situation involving a contribution to a 401(k) plan made after the end of the plan year. Rev. Rul. 90-105 holds that 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 not deductible by the employer for a taxable year, if the contributions are attributable to compensation earned by plan participants after the end of that taxable year. See also Rev. Rul. 76-28 (providing that a contribution made after the close of an employer's taxable year will be deemed to have been made on account of the preceding taxable year under section 404(a)(6) if, among other conditions, the payment is treated by the plan in the same manner as the plan would treat a payment actually received on the last day of such preceding taxable year of the employer), and Lucky Stores, Inc. v. Commissioner, 153 F.3d 964 (9th Cir. 1998), cert. denied, 526 U.S. 1111 (1999) (indicating, in

the context of a defined benefit plan, that the plain meaning of section 404(a)(6) precludes deduction in the preceding taxable year of grace period contributions that are required under collective bargaining agreements for work performed after the end of that preceding taxable year).

Several courts in addition to the Lucky Stores court, supra, have considered whether grace period contributions made pursuant to collective bargaining agreements, for work performed after the end of the taxable year, are "on account of" the preceding tax year within the meaning of section 404(a)(6). The courts have uniformly held that grace period contributions attributable to work performed in the subsequent tax year are not deductible in the prior tax year under section 404(a)(6). See Airborne Freight Corp. v. United States, 153 F.3d 967 (9th Cir. 1998); American Stores Co. v. Commissioner, 108 T.C. 178 (1997), aff'd, 170 F.3d 1267 (10th Cir. 1999), cert. denied, 528 U.S. 875 (1999); and Vons Companies, Inc. v. United States, 55 Fed. Cl. 709 (March 28, 2003).

The courts in Lucky Stores and Vons Companies relied on the plain meaning of section 404(a)(6) to conclude that the statute precludes an employer from deducting, for its current taxable year, payments attributable to compensation earned by plan participants after the end of that taxable year. The courts noted that the procedures that employers and plan administrators use to determine contribution amounts, based on the hours or weeks of employee service rendered during the immediately preceding month, clearly indicate that such contributions are not made "on account of" the employer's current taxable year as required by section 404(a)(6). Although these cases involved collectively-bargained multiemployer defined benefit plans rather than section 401(k) plan contributions, this aspect of the reasoning therein is equally applicable to section 401(k) plan contributions because, in both situations, contributions made by an employer relate to specific work performed by an employee for a particular period of time.

The facts addressed in Rev. Rul. 2002-46 are the same as the facts in Rev. Rul. 90-105, except for the addition of the plan amendment and the board resolution setting a minimum contribution for the plan year. Rev. Rul. 2002-46 concludes that these factual differences do not change the result. The plan amendment and the board resolution setting a minimum contribution for the plan year establish a liability, prior to the end of M's taxable year, to make that contribution. However, M's Post-Year End Service Contributions still are attributable to compensation earned by plan participants after the end of the taxable year. Neither the plan amendment nor the board resolution bears on when that compensation is earned. Thus, for example, the Post-Year End Service Contributions in the circumstances described are still on account of that subsequent taxable year rather than on account of the taxpayer's 2001 Taxable Year, and therefore cannot be deemed paid at the end of the 2001 Taxable Year under section 404(a)(6). The holding of Rev. Rul. 90-105 applies to the facts of Rev. Rul. 2002-46, and the Post-Year End Service Contributions are not deductible for the corporation's 2001 Taxable Year.

Moreover, since the Post-Year End Service Contributions are not on account of the taxpayer's 2001 Taxable Year within the meaning of Code section 404(a)(6) and therefore are not deemed paid in that tax year under Code section 404(a), economic performance with respect to the liability fixed by the plan amendment and board resolution has not occurred in that tax year.

Rev. Rul. 2002-46 and Notice 2002-48, 2002-2 C.B. 130, note that an alternative rationale for the holding in Rev. Rul. 90-105 was based on Treas. Reg. § 1.404(a)-(1)(b), which provides in pertinent part that contributions be "compensation for services actually rendered." Under this alternative, the earlier ruling reasoned that, until the services giving rise to the compensation (and thus the contribution) were performed, the services were not "actually rendered" within the

meaning of the regulation. Notice 2002-48 states that the Service will no longer rely on this alternative argument. The “compensation for services actually rendered” language in Treas. Reg. §1.404(a)-(1)(b) is relevant only where the reasonableness of an employee’s compensation is in question, and is not an appropriate basis upon which to determine the timing of deductions for the contributions described in Rev. Rul. 90-105 or in Rev. Rul. 2002-46.

Rev. Rul. 2002-46 further holds that a change in a taxpayer’s treatment of contributions to a method consistent with the ruling is a change in method of accounting to which sections 446 and 481 apply. A taxpayer wishing to change its method of accounting for contributions to a method consistent with Rev. Rul. 2002-46 must follow the automatic change in method of accounting provisions in Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, modified, and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432.) As described below, different provisions apply to (i) the taxpayer’s first taxable year ending on or after October 16, 2002, and (ii) subsequent taxable years. See Rev. Rul. 2002-73, 2002-2 C.B. 805.

For a taxpayer’s first taxable year ending on or after October 16, 2002, the scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply, provided the taxpayer’s method of accounting for contributions is not an issue under consideration for taxable years under examination at the time the Form 3115 is filed with the National Office. One way for a taxpayer’s method of contributions to become an “issue under consideration” is when the Service issues an Information Document Request (IDR) requesting information about transactions described in, or transactions substantially similar to those described in, Rev. Ruls. 90-105 or 2002-46.

For subsequent taxable years, the scope limitations in section 4.02 of Rev. Proc. 2002-9 do apply. Under these scope limitations, a taxpayer cannot file a Form 3115 with the National Office once it has been placed under examination (see sections 3.08 and 4.02 of Rev. Proc. 2002-9), unless the “window period” or director’s consent exception applies (see section 6.03 of Rev. Proc. 2002-9).

The following chart summarizes when a valid Form 3115 may be filed under these rules:

	First taxable year ending on or after 10/16/02	Subsequent taxable years
Taxpayer is under exam, and method is an “issue under consideration”	No*	No*
Taxpayer is under exam, and method is not (yet) an “issue under consideration”	Yes	No*
Taxpayer is not under exam	Yes	Yes

* assuming no window period applies

<u>CONCLUSION</u>

Grace period 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 not deductible by the employer for a specific taxable year, if those contributions are attributable to compensation earned by plan participants after the end of such taxable year.

This conclusion applies regardless of whether the employer's liability to make a minimum contribution is fixed before the close of that taxable year.

Further, a change in a taxpayer's treatment of contributions to a method consistent with the ruling is a change in method of accounting to which sections 446 and 481 apply.

TAXPAYER POSITION ISSUES 1, 2, & 3

Taxpayers involved in this transaction rely on an interpretation of the grace period under I.R.C. § 404(a)(6) provided by the transaction promoters. The promoters conclude that contributions made during the grace period are deductible in the preceding taxable year based on I.R.C. § 404(a)(6) which deems contributions made during the grace period to be made on the last day of the preceding taxable year.

The main focus is the amendment to the plan designed by the promoter to be adopted by the employer sponsoring the plan. This amendment purports to make the plan and the acceleration of deduction distinguishable from the transaction described in Rev. Rul. 90-105 and the court cases dealing with I.R.C. § 404(a)(6).

Promoters of this arrangement provide taxpayers with tax opinions regarding the accelerated deductions. These opinions conclude that "it is more likely than not" that grace period contributions are deductible in the preceding year. The promoters' opinions conclude that the reasons for the disallowance of grace period contributions set forth in Rev. Rul. 90-105 should be accorded little weight.

These opinions state that the Service's conclusion that Rev. Rul. 76-28 and I.R.C. § 404(a)(6) are not satisfied because the plan could not have treated the accelerated contributions made during the I.R.C.§ 404(a)(6) period as contributions made on the last day of the preceding tax year is not consistent with the language of I.R.C. § 404(a)(6). The promoters believe that the amendment they designed and recommended distinguishes the transaction and the plan from the transaction described in Rev. Rul. 90-105.

The promoters also believe that the transaction is not a tax shelter. They explain that the concept of a tax shelter is subject to broad interpretation and is under considerable scrutiny from Congress. This constrains them from offering firm assurance that the acceleration of deduction is not a tax shelter and they state that they cannot guarantee that the Service will agree in the absence of a favorable Private Letter Ruling.

In these opinions, the promoters state that the accelerated deduction depends on four conditions. Three of these conditions are under the complete control of the employer. These are:

1. The contribution must be paid before the due date of the tax return (including extensions).
2. The total amount claimed as a deduction must not exceed the I.R.C. § 404 limits based on compensation earned in the preceding tax year for which the deduction is sought.
3. The I.R.C. § 404(a) limit is to be applied as if each employer has a separate plan.

The fourth condition, under I.R.C. § 404(a)(6), is that the grace period contributions must be "on account of" the taxable year.

The quotation in the promoters' opinions from Lozano, Inc. v. Commissioner, 68 T.C. 366 (1977), is taken out of context. In Lozano, the court stated that it is difficult if not impossible, to calculate with accuracy during a taxable year the amount of the maximum deductible contribution because that computation depends upon the total compensation of participating employees throughout the taxable year for which the deduction is sought.

The promoters assert that the "on account of" standard means that additional grace period contributions are treated in the same manner as had they been made in the tax year in which deducted. They argue that in a single employer plan, amended based on the promoters' recommendation, the allocations are fixed by the terms of the plan and relate to specific services, but contributions and timing are not fixed, and thus not tied to specific services.

They believe that the IRS's interpretation of the "in the same manner" requirement in Rev. Rul. 90-105 is inconsistent with the "on account of" requirement in the statute as well as Rev. Rul. 76-28.

They also cite Private Letter Rulings issued by the Service in the late 1980's which allowed deductions made during the grace period as reflecting the Service's position. Some argue that the grace period contribution should be deductible because Notice 2002-48 allowed contributions to be deducted when paid by the end of the tax year when the amounts were attributable to compensation to be earned during the grace period.

The promoters conclude that the "in the same manner" requirement is satisfied based on the adoption of the amendment to the plan. Under the amendment, rather than becoming entitled to a contribution for each pay period in which salary is reduced, plan participants earn the right to an allocation equal to the amount of the reduction in their salary. The employee election under the plan can be to receive cash or an "accrual or other benefit". This is an allocation rather than contribution.

The plan amendment recommended by the promoter provides for the following:

- Before tax contribution by the employer is allocated to a member's account pursuant to a salary reduction.
- Employer contributions refer to an allocation to the member's account rather than payment of such contributions to a trust.
- Members may elect to decrease, or to forgo an increase, in the amount of compensation which the employer otherwise would have paid to the employee in cash.
- Participating member agrees to reduce or forgo an increase in compensation in return for an allocation of employer contribution to his account.

Participants under the amended plan are entitled not to contributions in return for services and a reduction in salary, but to an allocation of amounts contributed by the employer. Under the plan, as amended, the employer can make advance contributions. The amended plan, unlike most typical 401(k) plans, expressly permits advanced funding. Under the structure designed by the promoter, employer contributions are not identified as elective deferrals or matching contributions when made to the plan. All are transmitted as employer contributions and then allocated.

The promoters conclude that the plan and the grace period contributions to a 401(k) plan are distinguishable from the issue considered in Lucky Stores, supra, American Stores, supra, and other court cases dealing with I.R.C. § 404(a)(6).

The opinions also conclude that deduction of grace period contributions in the current year does not result in a change in accounting method. The change falls under the "change in the underlying facts" doctrine and as such, will not cause a change in the accounting method. Taxpayers were simply delaying funding contributions that in the past would have been made during the taxable year.

They conclude that grace period contributions are deductible as they are treated in the same manner for purposes of the I.R.C. § 404 limitation, as well as under the plan. These opinions state that, given the holding of Rev. Rul. 90-105, the IRS can be expected to challenge deductions based on the position specified in the opinions. The promoters believe that, although the issue is not entirely free from doubt, a court would "more likely than not" conclude that deducting the grace period contribution in the preceding year is allowable and does not constitute a change in accounting method.

ISSUE 4 - PENALTY

Whether the I.R.C. § 6662 accuracy-related penalty is applicable.

I.R.C. § 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations or (2) any substantial understatement of income tax. I.R.C. § 6662(a), (b); Treas. Regs. §§ 1.6662-1 through 1.6662-4.

COMPLIANCE POSITION - ISSUE 4

On January 14, 2002, in Announcement 2002-2, 2002-2 I.R.B. 304, the Service announced a disclosure initiative to encourage taxpayers to disclose their tax treatment of tax shelters and other items for which the imposition of the accuracy-related penalty may be appropriate if there is an underpayment of tax. In return for a taxpayer disclosing any item in accordance with the provisions of the announcement before April 23, 2002, the Service agreed to waive the accuracy-related penalty under I.R.C. § 6662(b)(1), (2), (3), and (4) for any underpayment of tax attributable to that item.

The disclosure initiative covered all items subject to the penalty, with certain exceptions, including an item resulting from a transaction that did not in fact occur, in whole or in part, but for which the taxpayer claimed a tax benefit on its return.

Since the transactions which are described in Rev. Ruls. 90-105 and 2002-46 are "listed transactions," examination teams developing an adjustment based on these rulings must, pursuant to LMSB directive, determine whether the accuracy related penalty under section 6662 applies (unless the taxpayer timely disclosed its participation in the transaction pursuant to the penalty initiative set forth in Announcement 2002-2). See Memorandum dated December 20, 2001, from then LMSB Commissioner Larry Langdon to all LMSB Executives, Managers and Examiners, the subject of which is "Consideration of Penalties in Listed Transactions and Other Abusive Tax Shelter Cases," and Memorandum dated August 21, 2003, from LMSB Commissioner Deborah Nolan and SBSE Commissioner Dale Hart to all LMSB and SB/SE Executives, Managers and Agents, the subject of which is "Coordination of Listed Transactions." The decision to assert or not assert a section 6662 penalty must be reviewed by the appropriate Director of Field Operations. Whether the section 6662 penalty applies is determined on a case-by-case basis, depending on the specific facts and circumstances of each case, under the legal standards for application of the penalty, as described in the following section.

Compliance recommends the assertion of the accuracy-related penalty under I.R.C. § 6662. This penalty is imposed on any portion of underpayment attributable to negligence or disregard of rules and regulations or the substantial understatement of income tax.

THE ACCURACY-RELATED PENALTY UNDER I.R.C. § 6662

I.R.C. § 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations or (2) any substantial understatement of income tax. See Treas. Reg. §§ 1.6662-1 through 1.6662-4. Treas. Reg. § 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, the maximum accuracy-related penalty which may be imposed on any portion of an underpayment is 20 percent, even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial understatement). See DHL Corp. v. Commissioner, T.C. Memo. 1998-461, aff'd in part rev'd in part, 285 F.3d 1210 (9th Cir. 2002).

a. Negligence or Disregard of Rules or Regulations

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See I.R.C. § 6662(c) and Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967); Neely v. Commissioner, 85 T.C. 934, 947 (1985).

A return position that has a reasonable basis is not attributable to negligence. A reasonable basis is a relatively high standard of tax reporting, one significantly higher than not frivolous or not patently improper. Thus, the reasonable basis standard is not satisfied by a return position that is merely arguable or colorable. Conversely, under Treas. Reg. § 1.6662-3(b)(3), a return position generally is considered reasonable where it is based on one or more of the authorities listed in Treas. Reg. § 1.6662-4(d)(3)(iii), taking into account the relevance and persuasiveness of the authorities and subsequent developments, even if the position does not satisfy the substantial authority standard defined in Treas. Reg. § 1.6662-4(d)(2). Moreover, the reasonable cause and good faith exception in Treas. Reg. § 1.6664-4 may relieve the taxpayer

from liability from the negligence penalty, even if the return position does not satisfy the reasonable basis standard. See Treas. Reg. § 1.6662-3(b)(3). Treas. Reg. § 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where "[a] taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be 'too good to be true' under the circumstances."

The phrase "disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. A disregard of rules or regulations is "careless" if the taxpayer does not exercise reasonable diligence in determining the correctness of a return position that is contrary to the rule or regulation. A disregard is "reckless" if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances demonstrating a substantial deviation from the standard of conduct observed by a reasonable person. A disregard of the rules and regulations is "intentional" where the taxpayer knows of the rule or regulation that it disregards. Treas. Reg. § 1.6662-3(b)(2).

The term "rules and regulations" includes provisions of the Internal Revenue Code, Treasury regulations, and revenue rulings or *notices* issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-3(b)(2). Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the disregard of rules and regulations component of the accuracy-related penalty if the return position was taken subsequent to the issuance of the notice or revenue ruling. However, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits. Treas. Reg. § 1.6662-3(b)(2). For reportable transactions entered into after December 31, 2002, however, taxpayers cannot rely on the realistic possibility standard to avoid the disregard of rules or regulations component of the accuracy-related penalty. Id.

The disregard of rules and regulations component of the accuracy-related penalty may not be imposed on any portion of underpayment due to a position contrary to rules and regulations if: (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations) and (2) in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation. This adequate disclosure exception applies only if the taxpayer has a reasonable basis for the position and keeps adequate records to substantiate items correctly. Treas. Reg. § 1.6662-3(c)(1). Moreover, for transactions entered into after December 31, 2002, the taxpayer must also disclose the transaction in accordance with Treas. Reg. § 1.6011-4 to meet the adequate disclosure exception. Treas. Reg. §§ 1.6662-3(a); 1.6662-2(d)(5).

b. Substantial Understatement of Income Tax

If a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the substantial understatement component of the accuracy-related penalty applies to the understatement unless the reasonable cause and good faith exception applies. A tax shelter item is any plan or arrangement a significant purpose of which is the avoidance or evasion of federal income tax. I.R.C. § 6662(d)(2)(C)(iii).

The arrangement described in this ASG (hereinafter referred to as the 401(k) Accelerator Transaction) is an arrangement by which the taxpayer claims an accelerated deduction for

pension contributions made during the section 404(a)(6) grace period which are not on account of the taxable year for which the deduction is claimed, as required by section 404(a)(6). The 401(k) Accelerator Transaction is a promoted transaction and the promoter materials highlight that the principal benefit of the 401(k) Accelerator Transaction is the saving of federal income tax. The saving of federal income tax is accomplished without any payment other than the amount agreed upon as the fee for the professional services of the promoter to implement the strategy. Accordingly, the 401(k) Accelerator Transaction is an arrangement a significant purpose of which is to avoid federal income tax. The accelerated deduction is directly attributable to the purpose of avoiding federal income tax. Thus, the 401(k) Accelerator Transaction is a tax shelter and the 401(k) Accelerated Deduction is a tax shelter item. See, I.R.C. § 6662(d)(2)(C)(iii); Treas. Reg. §§ 1.6662-4(g)(2) and (3). In addition, the Service has determined that 401(k) Accelerator Transaction is a tax avoidance transaction and a listed transaction. See Notice 2000-51 2001-34 I.R.B. 190 and Rev. Rul. 2002-46, 2002-29 I.R.B. 117. Therefore, whether the substantial understatement penalty applies is analyzed under the special rules applicable to items attributable to a tax shelter, and the taxpayer must demonstrate reasonable cause and good faith under I.R.C. § 6664(c)(1).

c. The Reasonable Cause Exception

The accuracy-related penalty does not apply to any portion of an underpayment with respect to which it is shown that there was reasonable cause and the taxpayer acted in good faith. I.R.C. § 6664(c)(1). Whether a taxpayer acted with reasonable cause and in good faith is determined on a case-by-case basis, taking into account all pertinent facts and circumstances. Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Treas. Reg. § 1.6664-4(b)(1).

For reportable transactions entered into after December 31, 2002, a taxpayer’s failure to disclose the transaction in accordance with Treas. Reg. § 1.6011-4 is a “strong indication” that the taxpayer did not act in good faith. Treas. Reg. § 1.6664-4(d). For reportable transactions entered into before that date, a taxpayer’s failure to disclose the transaction in accordance with Treas. Reg. § 1.6011-4 “could indicate” a lack of good faith. See Preamble to T.D. 8877 (2/28/2000).

Taxpayers may argue they are not liable for the accuracy-related penalty because they relied on the advice of professional tax advisors. However, reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Reliance on professional advice constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Treas. Reg. § 1.6664-4(c). See United States v. Boyle, 469 U.S. 241 (1985) (reasonable cause is established when a taxpayer shows that he reasonably relied on the advice of an accountant or attorney). In no event will a taxpayer be considered to have reasonably relied in good faith on advice unless all the requirements of Treas. Reg. § 1.6664-4(c)(1) are satisfied. However, the fact that the taxpayer satisfies the regulation will not necessarily establish that the taxpayer reasonably relied on the advice of a professional tax advisor or other advisor in good faith. For example, if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law, reliance may not be reasonable or in good faith. Treas. Reg. § 1.6664-4(c)(1).

For a taxpayer's reliance on advice to be sufficiently reasonable so as to negate possible liability for the accuracy-related penalty, the Tax Court has stated that a taxpayer must satisfy the

following three-prong test: (1) the advisor was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer gave the advisor the necessary and accurate information, and (3) the taxpayer actually relied in good faith on the advisor's judgment. Neonatology Associates P.A. v. Commissioner, 115 T.C. 43 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002).

Moreover, the advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purpose (and the relative weight of such purpose) for entering into a transaction and for structuring a transaction in a particular manner. Treas. Reg. § 1.6664-4(c)(1)(i). The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. Treas. Reg. § 1.6664-4(c)(1)(ii). Further, where a tax benefit depends on non-tax factors, the taxpayer also has a duty to investigate such underlying factors. The taxpayer cannot simply rely on statements by another person, such as a promoter. See Novinger v. Commissioner, T.C. Memo. 1991-289. Moreover, if the tax advisor is not versed in these non-tax factors, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54 (2d Cir. 2000); Freytag v. Commissioner, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990), aff'd on other grounds, 501 U.S. 868 (1991); Collins v. Commissioner, 857 F.2d 1383 (9th Cir. 1988).

Whether a corporation acted with reasonable cause and good faith is determined by considering all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(f)(1). A corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if there is substantial authority within the meaning of Treas. Reg. § 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that such treatment was more likely than not the proper treatment. Treas. Reg. § 1.6664-4(f)(2)(i). Under section 1.6664-4(f)(2)(i), a failure to satisfy these minimum requirements will preclude a finding of reasonable cause and good faith based (in whole or in part) on a corporation's legal justification.

The regulations provide that in meeting the requirement of reasonably believing that the treatment of the tax shelter item was more likely than not the proper treatment, the corporation may reasonably rely in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in Treas. Reg. § 1.6662-4(d)(3)(ii). Treas. Reg. § 1.6664-4(f)(2)(i)(B)(2). The weight accorded an authority depends on its relevance, persuasiveness, and the type of document providing the authority. Treas. Reg. § 1.6662-4(d)(3)(ii). That is, a case or revenue ruling or other authority having only some facts in common with the tax treatment at issue is not particularly relevant if the authority may be materially distinguished on its facts, or is otherwise inapplicable to the tax treatment in issue. For example, an authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently applying the pertinent law to the facts.

In addition to the above, Treas. Reg. § 1.6664-4(f)(2)(i)(B)(2) requires that the opinion unambiguously state that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Service. Therefore, the tax advisor's opinion should be reviewed to determine whether the taxpayer has met these requirements. Taxpayers that do not provide the advice on which they relied cannot meet the requirements of Treas. Reg. § 1.6664-4(f)(2)(i)(B)(2).

CONCLUSION

Compliance recommends the assertion of the accuracy-related penalty under I.R.C. § 6662. This penalty is imposed on any portion of underpayment attributable to negligence or disregard of rules and regulations or the substantial understatement of income tax.

TAXPAYER POSITION - ISSUE 4

Taxpayers generally have secured tax opinions from accounting and legal firms. They believe that these opinions are sufficient to warrant full concession of penalties proposed. These opinions generally provide that it is "more likely than not" – i.e., a greater than 50 percent likelihood – that the accelerated deduction is allowable. These opinions may also provide that it is "more likely than not" that the penalty under I.R.C. § 6662 will not apply based on the taxpayer's reliance on their professional tax opinion.

Appeals Settlement Guidance

Overview

As a general rule, contributions to qualified plans are deductible in the tax year when paid. The fact that an employer is an accrual taxpayer is not relevant. The one exception to the "when paid" requirement is I.R.C.§ 404(a)(6), which treats contributions as having been made on the last day of the preceding tax year if they are paid during the grace period and are "on account of" the preceding tax year.

The Service's interpretation of I.R.C. § 404(a)(6) is clearly set forth in Rev. Ruls. 76-28 and 90-105 as follows. Grace period contributions attributable to compensation earned after the tax year has ended are not "on account of" the preceding tax year and are not deductible in that tax year.

On 9/5/95, Compliance issued a Coordinated Paper ("CIP") based on the transaction described in Rev. Rul. 90-105. Appeals issued the Appeals Settlement Guidelines ("ASG") on 10/25/96. The guidelines provided that in light of the Government's successful litigation of the legal issue, no concession is warranted.

The Service in Rev. Rul. 2002-46 determined that the changes made by taxpayers and promoters in an attempt to distinguish their transactions from the transaction described in Rev. Rul. 90-105 were not significant enough to change the conclusion. Appeals concur with this determination.

ISSUES 1, 2 AND 3

Issues 1 & 2

A qualified 401(k) retirement plan offers participants an election to receive employer contributions in cash or to have these amounts contributed to the plan on their behalf. These amounts are based, in part, on amounts specified by the participants in their annual salary reduction agreements. Contributions attributable to such deferrals are required to be contributed to the plan in the same amount a participant's compensation has been reduced pursuant to the salary reduction agreement.

A 401(k) plan allows eligible employees the choice between receiving certain amounts in cash or directing the plan sponsoring employer to contribute these amounts to the qualified plan. Once contributed to the plan, these amounts are fully and immediately vested.

Section 401(k) became effective for plan years beginning after December 31, 1979 and offered an opportunity for employees to reduce their current federal and state income tax through such deferrals.

In the transaction described in Rev. Rul. 90-105, a taxpayer with a tax year ending on June 30, 1989 deducted elective deferrals and matching contributions attributable to compensation earned by plan participants during the tax year. This amount is deducted and allowed under I.R.C. § 404.

The taxpayer also claimed on the same tax return for the 1989 tax year, an additional deduction attributable to elective deferrals and matching contributions contributed after the end of the tax year and attributable to compensation earned during the grace period for 1989 (post-year end contributions. When these additional deductions were claimed in 1989, the plan participants were yet to earn the compensation for the grace period and their deferrals from such compensation were yet to be made.

What taxpayers attempted to do was expand the deduction period for one taxable period – to 18 months on the facts of Rev. Rul. 90-105, or to 20½ months where the tax year and plan year were more closely aligned. This is an indefinite acceleration of deduction of the grace period contribution amount.

Upon realizing that transactions described in Rev. Rul. 90-105 presented taxpayers with substantial litigation hazards, attempts were made to distinguish their transaction. Promoters recommended adopting a plan amendment and then, each tax year, a board resolution setting a minimum employer contribution for the plan year in order to establish a liability prior to the end of the tax year. These contributions were to be made during the grace period under I.R.C. § 404(a)(6), with the contribution obligation allegedly to be satisfied from elective deferrals and matching contributions attributable to compensation earned during the grace period after the tax year has ended.

Taxpayers argue that the liability was established before the end of the tax year and hence, such amount is deductible on the tax return for the preceding taxable year based on I.R.C. § 404(a)(6). The fact that these contributions are attributable to deferrals to be made after the end of the tax year and from compensation to be earned during the grace period after the tax year has ended is ignored or justified by the plan amendment they designed.

Congress determined that employers should be granted an additional time or a "grace period" to be able to gather information and accurately calculate their maximum deductible limits for a tax year that has closed. That additional time is the I.R.C. § 404(a)(6) grace period.

I.R.C. § 404 originated as § 23(p) of the 1939 Code as amended by § 162(b) of the Revenue Act of 1942. The 1942 Committee reports refer to an accrual-basis taxpayer's deferrals noting a taxpayer would not be allowed a deduction until the year in which the compensation was paid. H.R. Rep. No. 77-2333, at 106 (1942). In response to concerns from the public, Congress provided accrual-basis taxpayers a grace period, originally 60 days under sec. 23(p)(1)(E) of the 1939 Code, to allow them to determine the percentage limitation and make appropriate contributions. See Don E. Williams Company v. Commissioner, 429 U.S. 569, 576 (1977)

In 1948, the House Committee on Ways and Means sought to lengthen the grace period time. H.R. No. 80-2087. This proposal stalled in the Senate. But in 1954, the grace period was extended to coincide with the period for filing a return, thereby giving birth to I.R.C. § 404(a)(6) of the 1954 Code. In describing its purpose, the accompanying Senate report articulated that this merely allowed a taxpayer additional time to gather information and to make calculations based upon facts derived from the tax year just completed.

In Sec. 1013 of ERISA of 1974, Congress extended the grace period to cash-basis taxpayers. The legislative history of this provision again characterized it as "allowing taxpayers time after the close of their taxable year to determine the amount of their contributions to be made to the plan" H.R. Rep. No. 93-807, at [118](1974).

The legislative history of ERISA reveals Congress' purpose in extending the grace period to all taxpayers. It makes clear that such action was taken in recognition of the difficulty faced by taxpayers in computing the maximum deductible contribution before the close of the tax year. Congress did not intend to allow a taxpayer to elect a year in which additional deductions could be claimed based on elective deferrals and matching contributions attributable to compensation earned during the grace period after the tax year has ended. If that were the case, there would be no need for a grace period in which taxpayers could gather information and calculate their maximum deductible limit.

The sole effect of I.R.C. section 404(a)(6) is to deem a payment to have been made on the last day of the preceding taxable year. It does not make a contribution deductible in a taxable year in which the contribution could not otherwise be deducted. See Don E. Williams Company v. Commissioner, supra, detailing the history of I.R.C. section 404(a)(6).

The Court in Lozano, Inc. v. Commissioner, 68 TC 366 (1977), observed at p.370, n2:

> The legislative history makes clear that such action was taken in recognition of the difficulty faced by cash and accrual method taxpayers of computing the maximum deductible contribution before the close of that taxable year. In addition, it was thought that cash method taxpayers should be allowed to wait and compute the deduction after the close of the taxable year so that they would not be denied the opportunity to make the maximum deductible contribution. See H. Rept. No. 93-779 (1974), 1974-3, C.B. 244, 360 H. Rept. No. 93-807, p. 118 (1974); Conf. Rept. No. 93-1280 (1974), 1974-3, C.B. 415, 508.

The issue as described in Revenue Ruling 90-105 has not been litigated with respect to a 401(k) plan. However, the Courts of Appeal for the Ninth and the Tenth Circuits and the tax court have considered the issue of whether post-year-end contributions can be "on account of" a prior tax year, within the meaning of I.R.C. § 404(a)(6). They have uniformly held that they cannot. See Lucky Stores, Inc., 107 T.C. 1 (1996), aff'd, 153 F.3d 964 (9th Cir. 1998), cert. denied, 526 U.S. 1111 (1999); Airborne Freight Corp. v. U.S., 153 F3d 967(9th Cir. 1998); and American Stores v. Commissioner, 108 T.C. 178(1997), aff'd, 170 F.3d 1267 (10th Cir. 1999), cert. denied, 528 U.S. 875 (1999).

The issue of the I.R.C. § 404(a)(6) grace period was also considered in Vons Companies, Inc. v. U.S., 55 Fed. CL. 709 (March 28, 2003), which provided further support for the Service's interpretation of I.R.C. 404(a)(6) as set forth in Rev. Rul. 76-28, Rev. Rul. 90-105 and Rev. Rul. 2002-46. In Vons, the Court of Claims held that a company wasn't entitled to deduct post tax year end contributions to a multiemployer defined benefit pension plan using the section 404(a)(6) grace period, as the contributions weren't on account of the earlier year's work within the meaning of section 404(a)(6).

The Court began with the statute's language. The phrase "on account of" is defined in various dictionaries as "because of," "for the sake of," or "by reason of." This means that the deductibility of contributions must be causally connected to events that occurred during the year to which it is attributable and not events that happened thereafter. The statute was intended only to allow a taxpayer additional time to determine the amount of contributions attributable to the prior year and not to allow for enhanced deductions.

The concluding paragraph in Vons reflects the Court's plain construction of section 404(a)(6):

> The court will not paint the lily. Plaintiff has choreographed an intricate pavane based on the complexity of the pension laws and various nonprecedential constructions thereof but ultimately stumbles over a plain construction of section 404(a)(6) that is dictated by the statute's language, context and legislative history -- a construction that avails plaintiff naught. Despite plaintiffs' importunings, nothing precludes this court from applying that construction or the Commissioner, for that matter, "from collecting the tax lawfully due under the statute." Dixon, 381 U.S. at 74-75. Accordingly, consistent with the view of every court to have considered this issue, this court also finds that plaintiff is not entitled to the deductions claimed. see Vons, 51 Fed. Cl. at 7.

Although these cases involved collectively bargained multi-employer defined benefit plans, the reasoning in Lucky Stores and Vons is equally applicable to an I.R.C. section 401(k) plan, because the contributions made by an employer relate to specific work performed by the employee for a particular period of time.

The twist in the Rev. Rul. 2002-46 transaction is found in the plan. However, the amendment to the plan and the Board of Directors resolution does not distinguish the plan or the deductions claimed from the transaction described in Rev. Rul. 90-105. Amending the plan year to begin on the last day of the preceding tax year and the establishment of a minimum contribution to be deducted in the preceding tax year does not change I.R.C. § 404(a)(6) or Congress' intent in the enactment of I.R.C. § 404(a)(6).

The fact that the minimum contribution is attributable to and to be satisfied from compensation to be earned during the I.R.C. § 404(a)(6) grace period after the tax year has ended precludes such contributions from being "on account of" the preceding tax year or deductible in the preceding tax year. A plan amendment providing that grace period contributions are "on account of" the preceding year does not change the fact that they are not.

A 401(k) plan is not funded by a board resolution. It is a deferred compensation plan funded by participants' elective deferrals based on the plan provisions and the elective deferral agreements. The deferred amounts are to be contributed and allocated to the participants electing to defer compensation. The contributions are fully and immediately vested.

Review of the promoters' opinions and the courts' interpretation of I.R.C. § 404(a)(6) shows that this tax arrangement is based on an application of law in an unintended manner. In simple language, a taxpayer operates a 401(k) plan for many years following established rules and then purchases the idea of accelerating deductions from a promoter.

The promoters' opinion, that the additional deduction is justified, is based on their erroneous interpretation of I.R.C. 404(a)(6). However, to understand the purpose of I.R.C. § 404(a)(6) and how it applies to contributions to retirement plans, the legislative history of this Code section and the courts' interpretation of I.R.C. § 404(a)(6) are controlling.

The history of I.R.C. § 404(a)(6) as well as the intent of Congress as interpreted by several courts demonstrate that elective deferral contributions made during the grace period which are attributable to compensation earned after the end of the tax year are not deductible in the prior tax year. Such contributions cannot be "on account of" such year when elective deferrals are yet to be made and the compensation is yet to be earned. I.R.C. § 404(a)(6) only permits a taxpayer to make payments which are on account of a preceding tax year during the grace

period and deem such payments to have been made on the last day of such tax year. Section 404(a)(6) does not make a contribution deductible in a year in which it is clearly not deductible.

The taxpayers and promoters quote from the court's comments in Lozano to support their position yet Lozano clearly states that I.R.C. § 404(a)(6) was enacted due to the difficulty facing taxpayers in calculating with accuracy their maximum deductible limit for a tax year on the last day of such tax year. This difficulty is due to the computations' dependence on total compensation of participants earned during the tax year for which the deduction is sought. That does not mean that an additional deduction based on compensation earned during the grace period is allowable. If taxpayers can calculate their deductible limits at the end of the tax year and have such amount deducted, there is no need for a grace period to allow additional time for such calculation after the end of a tax year.

The argument that under a 401(k) plan as amended, allocations are fixed and relate to specific services, but contributions and timing of such contributions are not fixed and are not tied to specific services is based on an incorrect interpretation of law. Under a 401(k) plan, a participant elects to defer compensation. That amount is contributed and it is allocated to the employee. These amounts are fully and immediately vested.

Issue 3

Compliance concluded that the change imposed by the Service is a change in method of accounting under I.R.C. § 446 because the change represents a change in the treatment of a material item. Such change would require an adjustment under I.R.C. § 481(a) to prevent duplication of deductions under certain circumstances.

Some taxpayers and promoters argue that the required change in treatment of the deductions does not constitute a change in accounting method. They argue that the change is a "change in characterization". According to their argument, once a factual determination is made as to whether a contribution is made on account of a particular year, the issue of when the contribution is deductible is governed by statute. The law does not support that position.

Under I.R.C.§ 446(e) and Treas. Reg. § 1.446-1(e)(2), a taxpayer must secure the consent of the Commissioner before changing the method of accounting used to compute taxable income. A change in the method of accounting includes the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item, which involves the proper time for inclusion of the item in income or the taking of a deduction. The consistent treatment of a recurring material item, whether that treatment be correct or incorrect, constitutes a method of accounting.

Under § 404(a)(6), a contribution to a qualified cash or deferred arrangement shall be deemed to be made on the last day of the preceding taxable year if: (1) the contribution is made during the grace period; and (2) the contribution is made on account of services performed in the taxable year. The taxpayer consistently determined the timing of deductions for contributions to its qualified cash or deferred arrangement based only on the first criterion, i.e., all contributions that were made during the grace period. The Service will require the taxpayer to apply both criteria in determining the proper time for deducting contributions to the plan. Accordingly, the change in the proper time for deducting the contributions is a change in method of accounting under I.R.C. §§ 446 and

481. See H.F. Campbell Co. v. Commissioner, 53 T.C. 439, aff'd. 443 F.2d 965 (6th Cir. 1971) (use of only two criteria in lieu of four criteria previously used to determine the timing of income is a change in accounting method).

Taxpayers also argue that the current IRS position is inconsistent with a Technical Advice Memorandum issued in 1982 and a series of Private Letter Rulings. I.R.C. § 6110(j)(3) prohibits using or citing a written determination as a precedent unless regulations provide otherwise. This is not the case here and therefore, these must give way to the statute.

Another argument is that Notice 2002-48 allowed amounts attributable to compensation earned during the grace period to be deducted when the contributions were paid by the end of the tax year. Notice 2002-48 did not involve grace period contributions and the Service decided that it would not challenge such deduction but would review these issues and issue guidance. Under Notice 2002-48, I.R.C. § 404(a)(6) was not an issue.

Another argument presented by some taxpayers is their belief that they should benefit from the "settlement" offered under Rev. Rul. 2002-46. Rev. Rul. 2002-46 (as modified by Revenue Ruling 2002-73, 2002-2 C.B. 805) stated that a change in a taxpayer's treatment of contributions to a method consistent with the Revenue Ruling is a change in method of accounting to which §§ 446 and 481 apply and provided a limited waiver to the scope limitations under Revenue Procedure 2002-9. The ruling provided an opportunity for a taxpayer to receive automatic consent to change its method of accounting by following the provisions in Rev. Proc. 2002-9 as modified by Rev. Proc. 2002-19.

Revenue Ruling 2002-46 (as modified by Rev. Rul. 2002-73) addressed the acceleration of deductions for contributions to 401(k) plans. Taxpayers desiring to change their method of accounting to correct the treatment of the deductions had the opportunity to take advantage of the favorable terms of change provided for voluntary changes in accounting method under Rev. Proc. 2002-9. Under Rev. Proc. 2002-9, taxpayers could prospectively change their method of accounting for the issue for the first tax year ending on or after October 16, 2002, provided the issue was not under consideration in a tax year under exam at the time the Form 3115 is filed. Thus rather than having to pick up the accelerated amount in the first year it was claimed, they were allowed to spread the amount deducted over a four year period, beginning in the year of change.

In the accounting method area, taxpayers can initiate a change in method of accounting after contact by examination only if they are in a window period and the accounting method is not an issue under consideration by Examination.

Rev. Rul. 2002-46 allowed a taxpayer who had set up an arrangement described in the ruling, and claimed deductions deemed improper under the ruling, to file a Form 3115 for an automatic change in accounting method to correct the situation—and the taxpayer could do this up until the time the arrangement became "an issue under consideration" in a tax audit. If the taxpayer applied for such an automatic change, it would be allowed to change its method of accounting for those contributions prospectively. The ruling gave "audit protection" for any prior years in which the taxpayer might have accounted for the contributions by improperly accelerating them. Rev. Rul. 2002-73 modified Rev. Rul. 2002-46 by providing that the favorable method change was only available for a limited period of time.

The accounting method procedural rules contained in Rev. Rul. 2002-46 are an exercise of the Commissioner's discretion under § 446(e), and as such are subject to review under an abuse of discretion standard. See Capitol Federal Savings & Loan Assoc. & Subs. v. Commissioner, 96 T.C. 204 (1991). Some taxpayers may argue that the Commissioner has abused his discretion by excluding taxpayers that have a § 404(a)(6) accounting method issue under consideration from the scope of the automatic change in accounting method consent procedures. Thus, the "issue under consideration" standard presents the following issues: (i) whether taxpayers whose method of accounting is an issue under consideration are similarly situated to taxpayers whose method of accounting is not an issue under consideration; and (ii) if so, whether there is a rational basis for treating these groups of taxpayers differently.

The "issue under consideration" concept is rooted in the carrot-and-stick approach to encouraging taxpayers to voluntarily comply with proper methods of accounting. The terms and conditions of an accounting method change are more favorable if voluntarily made prior to examination placing the issue under consideration. Without this incentive, taxpayers would literally play the audit lotto and wait to be contacted for examination and take their chances then. Hence, the rationale and basis for the concept of issue under consideration has significance in encouraging voluntary compliance in a world of limited audit resources. This is much more than the mere "administrative efficiency" rationale rejected in Computer Sciences Corp. v. United States, 2001-2 USTC 50,635.

A taxpayer under examination that seeks to change from an improper method of accounting is not similarly situated to a taxpayer not under examination that seeks to change its improper method of accounting. The first difference between the two is the apparent degree of voluntary compliance. The former taxpayer has delayed changing to a proper method of accounting until it has been contacted by Examination; the latter taxpayer has initiated the change to a proper accounting method without any contact by Examination. In the former case, the change is likely motivated by the fear that the improper accounting method will be detected in the examination; in the latter case, the taxpayer has far less reason to fear detection of its improper accounting method, and the change is more likely to be truly voluntary.

The second significant difference is the amount of resources expended by the Service in achieving compliance. The former taxpayer initiated its accounting method change only after the Service expended significant resources to begin an examination. The latter taxpayer initiated its accounting method change without any expenditure of Service resources.

Similarly, a taxpayer in a window period with its method of accounting as an issue under consideration is not similarly situated with a taxpayer in a window period whose accounting method is not an issue under consideration by the Service. The former taxpayer has delayed changing to a proper method of accounting until the examiner began to focus on the taxpayer's improper accounting method, and is less likely to be acting on a purely voluntary basis; the latter taxpayer sought to change its improper method before the examiner began to focus on the improper method, and thus the change is more clearly voluntary in nature. In addition, more Service resources have been expended in connection with the former taxpayer than the latter.

In Capitol Federal Savings & Loan, the Tax Court considered the reasonableness of the Service's procedural rules for handling accounting method change requests by taxpayers that had been contacted for examination. The court stated that the Service "has a legitimate interest in ensuring that, where a taxpayer is under examination, the District Director's efforts are not compromised or defeated by the action of another department within the Internal Revenue Service. Such a compromise could occur if the National Office were to consider an accounting method issue which might otherwise be the subject of the District Director's examination and determination." Capital Federal Savings & Loan, 96 T.C., at 224. The Capital Federal Savings & Loan court's statement carries even greater force in the context of an "issue under consideration" standard because of the increased likelihood (and, in the case of a Rev. Rul. 90-105 or Rev. Rul. 2002-46 issue, the certainty) that the issue will be the subject of the examination and determination. Therefore, it is clear that the Service has a rational and reasonable basis for distinguishing between taxpayers that already have an accounting method issue under consideration by the Examination Division and taxpayers that do not have an issue under such consideration. The Service did not abuse its discretion under § 446(e) by excluding taxpayers with a § 404(a)(6) accounting method issue from the automatic accounting method change consent procedures of Rev. Rul. 2002-46.

Taxpayers that were provided a notice placing the issue under consideration by Examination prior to filing a Form 3115 cannot take advantage of Rev. Rul. 2002-46. The prospective accounting method change and audit protection are not available. These taxpayers are not similarly situated with respect to taxpayers who file for a voluntary change and who do not have this issue under consideration by Examination. The "issue under consideration" standard provides a rational basis for distinguishing between taxpayers seeking to change their accounting methods

ISSUE 4

All the facts and circumstances developed during the examination of the taxpayer should be considered in determining the applicability of the section 6662(a) accuracy-related penalty. Reference is hereby made to the earlier discussion of the law.

The 401(k) Accelerator Transaction is an arrangement by which the taxpayer claims an accelerated deduction for pension contributions made during the section 404(a)(6) grace period which are not on account of the taxable year for which the deduction is claimed, as required by section 404(a)(6). The 401(k) Accelerator Transaction is promoted as an indefinite book to tax difference. The promoters' materials highlight that the principal benefit of the 401(k) Accelerator Transaction is the saving of federal income tax. The saving of federal income tax is accomplished without any payment other than the amount agreed upon as the fee for the professional services of the promoter to institute the strategy. As such, the 401(k) Accelerator Transaction is an arrangement a significant purpose of which is to avoid federal income tax and the accelerated deduction is directly attributable to the purpose of the 401(k) Accelerator Transaction to avoid federal income tax. Accordingly, the 401(k) Accelerator Transaction is a tax shelter and the 401(k) Accelerator Deduction is a tax shelter item. I.R.C. § 6662(d)(2)(C)(iii); Treas. Reg. §§ 1.6662-4(g)(2) and (3). In this regard, the Service has determined that 401(k) Accelerator Transaction is a tax avoidance transaction and a listed transaction. Therefore,

analysis of the applicability of the substantial understatement penalty under the special rules applicable to items attributable to a tax shelter must be completed.

Rev. Rul. 90-105 and Rev. Rul. 2002-46 concluded that grace period contributions are not deductible in the preceding tax year. The transaction described in Rev. Rul. 90-105 was identified as a coordinated issue in Compliance and an Appeals Settlement Guidelines was issued in 1996. The modifications made by taxpayers and promoters in an attempt to distinguish their transaction from the transaction described in Rev. Rul. 90-105 did not change the essential facts. The transaction is substantially similar to the transaction described in Rev. Rul. 90-105.

Reliance on the opinion of a tax professional by a corporate participant in a tax shelter is insufficient on its own to constitute reasonable cause. First, reliance may not satisfy the "belief" requirement set forth in Treas. Reg. § 1.6664-4(f)(2)(B). Second, the corporate participant in a tax shelter must also satisfy the substantial authority requirement of Treas. Reg. § 1.6664-4(f)(2)(A). As the foregoing discussion explains, there is not substantial authority to support the validity of the shelter

Reliance may be unreasonable when it is placed upon insiders, promoters, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about. See Goldman v. Commissioner, 39 F.3d 402, 408 (2d Cir. 1994), aff'g T.C. Memo. 1993-480; LaVerne v. Commissioner, 94 T.C. 637, 652-53 (1990), aff'd by unpublished opin., 956 F.2d 274 (9th Cir. 1992); Marine v. Commissioner, 92 T.C. 958, 992-93 (1989), aff'd by unpublished opin., 921 F.2d 280 (9th Cir. 1991). See also Neonatology, supra. Furthermore, large corporations with highly sophisticated tax professionals in their employ should be held to a high standard in determining whether advice they receive is accurate.

Although satisfaction of the "authority" and "belief" requirements is a necessary prerequisite to a reasonable cause finding, satisfaction of these minimum standards is not necessarily dispositive. Treas. Reg. § 1.6664-4(f)(3). For example, reliance on tax advice may not be reasonable if the taxpayer's participation in the tax shelter lacked a significant business purpose. Id.

SETTLEMENT POSITION

ISSUES 1 & 2

Appeals believes that the main issue is the meaning of I.R.C. § 404(a)(6). This section was enacted as a grace period to allow taxpayers to gather information and calculate their deductible limit. This was clearly explained by the courts and by the legislative history of that section. Congress' intent was clear. There is no ambiguity.

For contributions made during the I.R.C. § 404(a)(6) period to be deductible in the preceding year, it must be "on account of" such year. This is clearly not the case here.

The argument that such an amount is deductible based on I.R.C. § 404(a)(6) is inaccurate and the reasoning provided by the taxpayers and the promoters cannot prevail.

The courts' interpretation of I.R.C. §404(a)(6) is clear and persuasive. The litigation hazards for the government are at best minimal. The arguments presented in support of the deductibility of grace period contributions present a position contrary to the intent of Congress.

The issue of deducting grace period contributions as described in Rev. Rul. 90-105 was coordinated by Compliance and Appeals in 1996. The Coordinated Issue Paper (CIP) and Appeals Settlement Guidelines (ASG) were issued in 1995 and 1996, respectively. Therein, Appeals recommended the full sustention of the government's position.

The Service in Rev. Rul. 2002-46 determined that the changes made by taxpayers and promoters in an attempt to distinguish their transaction from the transaction described in Rev. Rul. 90-105 were not significant enough to change the result. Appeals concur with this evaluation. Consequently, no concession should be offered on this issue.

Issue 3

Whether a taxpayer can take advantage of the provisions of Rev. Rul. 2002-46 is a factual issue. A taxpayer who cannot establish that a change in accounting method was timely requested, before the deduction issue was placed under consideration, cannot take advantage of the relief granted under Rev. Rul. 2002-46. They are simply too late. The change in the treatment of contributions by claiming contributions made during the I.R.C. 404(a)(6) grace period is a change in accounting method to which §§ 446 and 481 apply.

The hazards to taxpayers are very substantial. As such, no settlement, other than full disallowance of the accelerated deduction, should be made.

Issue 4

Appeals Officers must evaluate the penalty issue and render a decision on the merits of the issue. Appeals Officers must provide a narrative discussion to support their determination as to

whether the section 6662(a) penalty does or does not apply. Any hazards of litigation must be articulated therein.

Whether the accuracy-related penalty does or does not apply to the underpayment attributable to the disallowance of deductions claimed from the transaction must be determined on a case-by-case basis. The legal standards for application of penalties must be applied to the specific facts and circumstances of each case to determine whether and to what extent the penalty application is appropriate.

If a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy-related penalty applies to the resulting underpayment of tax unless the reasonable cause and good faith exception applies. A tax shelter item is any plan or arrangement a significant purpose of which is the avoidance or evasion of federal income tax. I.R.C. § 6662(d)(2)(c)(iii).

The 401(k) Accelerator Transaction is an arrangement by which the taxpayer claims an accelerated deduction for pension contributions made during the § 404(a)(6) grace period which are not on account of the taxable year for which the deduction is claimed, as required by § 404(a)(6). This transaction is a promoted transaction and the promoter materials highlight that the principal benefit of the transaction is the saving of federal income tax. The accelerated deduction is directly attributable to a significant purpose of avoiding federal income tax. Thus the transaction is a tax shelter and the accelerated deduction is a tax shelter item. I.R.C. § 6662(d)(2)(c)(iii) and Treas. Reg. § 1.6662-4(g)(2) and (3). The Service has also identified the transaction as a tax avoidance transaction in Notice 2000-51, 2001-34 I.R.B. 190, and Rev. Rul. 2002-46. Therefore, whether the substantial understatement component of the accuracy-related penalty applies is analyzed under the special rules applicable to items attributable to a tax shelter. If the penalty does apply, the taxpayer must demonstrate reasonable cause and good faith under I.R.C. § 6664(c)(1) and Treas. Reg. § 1.6664-4(f) to avoid imposition of the accuracy-related penalty.

-END-