Tax Accounting

BY JAMES E. SALLES

In this month's column,

- Proposed regulations under Code Section 457 make waves by requiring current taxation of untraded options;
- An IRS procedure addresses utility "financing orders";
- The IRS business plan promises a generous helping of tax accounting guidance over the next year.

SECTION 457 REGULATIONS

In June, the IRS released proposed regulations under Code Section 457, which deals with deferred compensation arrangements involving tax-exempt employers.[1] The proposal would represent the first amendment to the regulations since 1982, and is evidently on a fast track, as the IRS's 2002-03 business plan lists final regulations among the items scheduled for completion in the year ended June, 2003.[2] The bulk of the proposed regulations relate to plans that are specially designed to be "eligible plans" under Code Section 457, and fall outside the scope of this column. However, the provisions governing "ineligible plans" are of broader relevance. One aspect of these in particular is likely to attract attention because it could significantly impact the tax treatment of options granted by tax-exempt employers.

Background

Code Section 457, and the new proposed regulations, must be understood against the background of basic tax accounting principles. In general, a cash basis taxpayer only recognizes income upon the actual or constructive receipt of cash or something that the tax code recognizes as "property." Generally a promise to pay by the other party to the transaction — the taxpayer's customer, or in the services context, the recipient of services ("employer") — will only be recognized as "property" if it represents either a "cash equivalent" or an "economic benefit." A cash equivalent, as its name implies, must be marketable.[3] To constitute an "economic benefit," the right to payment must be payable from, or at least secured against, a trust or other segregated fund or property that is not available to the employer's general creditors.[4]

For this reason, the regulations under Code Section 83 (which displaced, and largely codified, this existing law so far as concerns transactions involving services) provide that a mere "unfunded and unsecured promise" is not a "transfer" of "property" that triggers tax. Cash basis taxpayers thus have a lot of leeway to pile up rights to compensation for services performed in the past. So long as the deferral arrangement is made sufficiently in advance to avoid "constructive receipt" of the income, and so long as the employer's promise to pay avoids the twin pitfalls of "cash equivalence" and "economic benefit," a cash basis service provider will not be taxed. The price to be paid is that while the employee's income is deferred, so is the employer's deduction. Code Section 404(a)(5) generally defers deductions for amounts paid under a deferred compensation plan—apart from "qualified" plans that meet complex ERISA and tax restrictions—until the close of the taxable year in which the recipient has income.

A similar matching principle underlies Code Section 83's special scheme for options. Unless the options that the employee receives have "readily ascertainable market value"—which generally means that they are publicly traded—then the "transfer" of "property" does not take place until the employee exercises or disposes of the options. The employer's deduction is likewise deferred, preserving the basic tradeoff: no income, no deduction.

Code Section 457

That tradeoff breaks down, however, when a government or other tax-exempt entity is involved. Tax-exempt employers don't care about deductions, so it costs them nothing to agree to defer paying compensation for lengthy periods. Earnings subject to such an agreement could continue to compound tax-free so long as the employees were willing to put off actually laying hands on the money.

Congress has tried to deal with this problem in Code Section 457. The history of this provision is somewhat involved. In early 1978, the IRS issued proposed regulations that would have set aside the traditional doctrine of constructive receipt for nonqualified deferred compensation plans generally. These regulations would have provided for current taxation of any amount that was "at the taxpayer's individual option, deferred to a taxable year later than that in which such amount would have been payable but for his exercise of such option."[5] Congress responded in an uncodified provision of the Revenue Act of 1978 that provided that the timing of income from "any amount covered by a private deferred compensation plan shall be determined in accordance with the principles . . . which were in effect on February 1, 1978,"[6] meaning before the proposed regulations were issued. The earliest incarnation of Code Section 457 was added in a companion provision,[7] which essentially codified the proposed regulations for

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plans maintained by state and local governments, except for certain "eligible plans" falling within statutory limits.

As the regulatory moratorium imposed by the Revenue Act of 1978 only applies to plans maintained by taxable private employers, and Code Section 457 as initially enacted only applied to government plans, the proposed regulations might still have been finalized to apply to private nonprofit employers, but the IRS never acted to do this. In 1986, Congress filled the void by extending Code Section 457 to all tax-exempt employers, private and governmental.[8] In general, apart from "eligible plans" meeting tight statutory criteria—generally, the amount deferred may not exceed $11,000 annually—Code Section 457 requires that compensation from a tax-exempt employer be reported when it is earned if the employee has a fixed right to receive it. This rule applies even to promises to pay that are "unfunded and unsecured" and would therefore not normally be taxable. Within its sphere of operation, therefore, Code Section 457 trumps not only Code Section 83 and the related doctrines of "cash equivalence" and "economic benefit," but also the well-established case law concerning "constructive receipt."

The Proposed Regulations

The proposal completely rewrites the existing regulations under Code Section 457. Proposed Regulations §§ 1.457-1 through -2 provide an overview of that section's operation. Proposed Regulations §§ 1.457-3 through -10 apply to "eligible plans." The rules governing "ineligible plans"—that is, payments for services provided to a tax-exempt employer that are *not* made under an "eligible plan"—are found in Proposed Regulations § 1.457-11, and it is to these we now turn.

The general rule under Code Section 457 is that amounts deferred under an "ineligible plan"—including any earnings—become includable in the service provider's income when there is no longer any "substantial risk of forfeiture."[9] "Substantial risk of forfeiture" is a term of art derived from Code Section 83. Such a risk exists while the recipient still has to perform "substantial services" before becoming entitled to receive the money. Generally, there will no longer exist a "substantial risk of forfeiture" after the services are performed, unless there is some other "condition related to the purpose of the transfer" that has to be met before the service provider's rights to the property vest.[10] In practice, therefore, Code Section 457 requires the service provider to include income from an ineligible plan when the related services are performed, unless the plan imposes some special vesting requirement.

Once the service provider has reported the initial deferred amount, earnings that later accrue are generally not taxed until they become payable, so long as the service provider does not have preferential rights as a creditor.[11] The regulations do not state what will happen if the employee *does* have preferential rights. Frequently, in such circumstances, if the service provider's rights are vested there will be an "economic benefit" (and a transfer of property under Code Section 83) which will trigger current taxation. However, the precise boundaries of the economic benefit doctrine, and of "property" under Code Section 83, are not wholly clear. It is uncertain, for example, under what circumstances there might exist an economic benefit (or "property") if a state law granting preference to claims for back wages applied but assets were not otherwise segregated from creditors. Moreover, in the ordinary economic benefit case, the recipient is not taxed currently on later income from the property unless there is a trust to which Code Section 402(b)(4)(A) applies.

Relationship with Section 83: The Options Problem

The special rules for "ineligible plans" under Code Section 457 do not apply to "that portion of any plan which consists of a transfer of property described in section 83."[12] However, the proposed regulations, unlike the current regulations, include a lengthy new paragraph entitled "coordination of section 457(f) with section 83."[13] Among other things, this paragraph provides that Code Section 457 *does* apply if there is a transfer of property, but "the date on which there is no substantial risk of forfeiture . . . precedes the date on which there is a transfer of property to which section 83 applies."

As discussed above, the conveyance of an untraded option is not considered a transfer of property under Code Section 83. The transfer takes place when the employee or other service provider exercises the option, and receives the underlying security. The current regulations date from when Code Section 457 only covered state and local governments and do not directly address options, and many taxpayers have assumed that untraded options need not be taken into account in calculating the amount deferred under an ineligible plan. The passage quoted above, however, appears to compel recipients to report income from options at grant (presumably at their then-fair market value), if they are received in connection for services performed for a tax-exempt. The intent was evidently to crack down on mutual fund option plans maintained by tax-exempts.[14] This reading is confirmed by a special transition rule, which provides that the new paragraph will not apply to options without readily ascertainable market value granted on or before May 8, 2002.[15]

The point is likely to be a sensitive one as the proposed regulations proceed toward finalization. One practitioner noted that treating options this way would create stark differences between the treatment of option plans of tax-exempt employers and that of similar plans maintained by ordinary taxable employers.[16] However, this is the same

discrepancy that has long existed in connection with other types of nonqualified deferred compensation arrangements.

UTILITY FINANCING ORDERS

Background

In late June, the IRS issued Revenue Procedure 2002-49,[17] addressing utility "financing orders" issued by regulatory authorities. If the procedure's conditions are met, utilities will not be required to recognize income from receipt of such orders or when they are securitized under commonly used structures.

Utility "financing orders" are a side effect of the ongoing deregulation of the energy industry. As part of the changeover to a competitive market, state regulators often issue "financing orders" entitling utilities to collect transition charges from its historical customers. Entering into an executory contract, even on advantageous terms, does not trigger income. Several cases have held that a utility is not entitled to a deduction when regulators require it to sell at below-market rates to compensate for past "excess" charges.[18] Similarly, an ordinary rate order that merely gives the utility the right to layer on an extra charge for electricity to be supplied in the future does not trigger income.

Financing orders, however, have some characteristics that distinguish them from mere executory contracts, or garden-variety rate orders. They generally entitle the utilities to collect "transition charges" from area consumers. These charges are meant to assist the utility in recouping prior investments under the regulated scheme, and are generally "non-bypassable," meaning that they are payable not only by the utility's current customers but also former customers that are not currently buying power. Moreover, the utilities generally have limited power to assign their rights, and the resulting income stream is commonly securitized, so that the financing orders might be argued to be some sort of cash equivalent. Consequently, over the past few years, there have been several private ruling requests by utilities seeking to confirm that the IRS will not argue that either the financing orders themselves or the proceeds of their securitization represent income.[19]

Revenue Procedure 2002-49

Revenue Procedure 2002-49 provides that if a financing order is issued under authority of "transition legislation" passed by a state legislature that specifically contemplates securitization, and the utility undertakes a "qualifying securitization," neither the issuance of the order or the securitization will trigger income to the utility.

A "qualified securitization" is the issuance of debt obligations secured by the utility's rights to receive future income under the financing order. Typically, this is accomplished through a special purpose entity that qualifies as a grantor trust or another type of "tax nothing." The revenue procedure provides that the utility must capitalize the entity that issues the debt with assets (apart from the financing order) that amount to at least one-half of one percent of the principal amount to be issued. Presumably this requirement is imposed to establish the utility's ownership of the "tax nothing" and that the entity's debt is the utility's debt. For reasons not made clear, the procedure also requires that the debt provide for level payments of principal and interest (that is, it has to be "self-amortizing," like a typical home mortgage).

Revenue Procedure 2002-49 exemplifies what appears to be a trend in recent tax accounting guidance. The IRS, while steering clear of enunciating broad principles of law, prescribes a reasonable treatment for a commonly encountered transaction. Without some indication of the reasoning underlying the conclusion, it can be hard to draw analogies and discern the IRS's likely position in similar situations. Such guidance, however, nonetheless serves a valuable purpose when it allows routine transactions to go ahead and heads off repetitive requests for comfort rulings. The procedure is thus likely to be welcomed by affected taxpayers.

MORE GUIDANCE ON THE WAY

Early July saw the IRS issue its 2002-03 business plan, which, according to the accompanying announcement, will now be updated quarterly, instead of annually, as in the past. A number of the agenda items promise one form or another of guidance on various tax accounting issues.

Some of the issues included on the business plan were selected through the ongoing Industry Issue Resolution (IIR) Program. One of these issues was the treatment of preproduction costs for creative property under the uniform capitalization rules. The IRS also promises guidance as to when utility's expenditures on power generation equipment are capitalizable improvements as opposed to deductible maintenance costs, although it declined similar projects involving equipment used in power transmission and distribution.[20]

Other tax accounting-related items on the plan include:

1. Revision of Revenue Procedure 71-19,[21] which sets forth the IRS's ruling position as to the application of "constructive receipt" principles to agreements to defer compensation;
2. Regulations under Code Section 263(g), which requires capitalizing interest and other carrying costs relating to straddles;
3. More guidance on "split-dollar" life insurance arrangements;[22]
4. Revision of Revenue Procedure 97-27,[23] the procedure that sets out the IRS's conditions for consent to voluntary changes of accounting method;

5. The long-awaited proposed regulations under Code Section 263 on the capitalization of expenditures relating to intangibles;[24]
6. Final regulations under Code Section 446, dealing with accounting methods for transactions among members of a corporate consolidated group;[25]
7. Proposed regulations on the "nonaccrual experience method" of accounting under Code Section 448, presumably to implement the recent statutory changes;[26]
8. Guidance under Code Section 451 regarding the treatment of advance payments, which may mean an upcoming revision of Revenue Procedure 71-21;[27]
9. Guidance under Code Sections 451 and 461 on disputed amounts, Medicaid rebates, and tax refunds; and
10. Final regulations under Code Section 468B, which presumably will relate to the existing proposed regulations dealing with "disputed settlement funds" and various types of escrows.[28]

1. REG-105885-99, 2002-23 I.R.B. 1103.

2. IRS Priority Guidance Plan, 2002 TNT 133-8 (July 10, 2002), "Employee Benefits," Item A-19.

3. See generally, e.g., Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975); Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961).

4. See, e.g., Sproull v. Commissioner, 16 T.C. 244 (1951).

5. Prop. Reg. § 1.61-16(a) (Feb. 3, 1978).

6. Revenue Act of 1978, Pub. L. No. 95-600, § 132.

7. Revenue Act of 1978, Pub. L. No. 95-600, § 131, *codified at* I.R.C. § 457.

8. Tax Reform Act of 1986, § 1107, *codified at* I.R.C. § 457.

9. Prop. Reg. § 1.457-11(a).

10. I.R.C. §§ 83(c)(1), 457(f)(3)(B); Reg. § 1.83-3(c).

11. Prop. Reg. § 1.457-11(a)(3).

12. I.R.C. § 457(f)(2)(C); Reg. § 1.457-3(b)(4); Prop. Reg.§ 1.457-11(b)(3).

13. Prop. Reg. § 1.457-11(c).

14. See C. LaFon & F. Stokeld, "Deferred Compensation Regs Could End Mutual Fund Options by EOs, Says Practitioner." 65 Daily Tax Highlights & Documents 1740 (May 10, 2002).

15. Prop. Reg. § 1.457-12.

16. *Id.*

17. 2002-29 I.R.B. 172.

18. E.g., MidAmerican Energy Co. v. Commissioner, 271 F.3d 740 (8th Cir. 2001), *aff'g* 114 T.C. 570 (2000), discussed in J. Salles, "Tax Accounting," 2(11) *Corp. Bus. Tax'n Monthly* 34, 36-37 (August, 2001).

19. E.g., LTRs 200020043, 200020045 and 200020046 (Feb. 18, 2000), discussed in J. Salles, "Tax Accounting," 1(11) *Corp. Bus. Tax'n Monthly* 26, 31 (August, 2000).

20. IR-2002-89 (July 10, 2002), 2002 TNT 133-8.

21. 1971-1 C.B. 698.

22. See earlier discussions in J. Salles, "Tax Accounting," 2(4) *Corp. Bus. Taxation Monthly* 23 (July, 2001) and 3(8) *Corp. Bus. Tax'n Monthly* 33, 36-38 (May, 2002).

23. 1997-1 C.B. 680, *modified by* Rev. Proc. 2002-19, 2002-13 I.R. 696, discussed in J. Salles, "Tax Accounting," 3(9) *Corp. Bus. Tax'n Monthly* 31, 35-36 (June, 2002).

24. See Advance Notice of Proposed Rulemaking, REG-125638-01, RIN 1545-BA00, discussed in J. Salles, "Tax Accounting," 3(8) *Corp. Bus. Tax'n Monthly* 33, 33-35 (May, 2002).

25. See Prop. Reg. § 1.446-1(c)(2)(iii), REG-125161-01 (Nov. 6, 2001), discussed in J. Salles, "Tax Accounting," 3(4) *Corp. Bus. Tax'n Monthly* 34, 37-38 (January, 2002).

26. Job Creation and Worker Protection Act of 2002, Pub. L. No. 107-147, § 403(a), 116 Stat. 21, 40-41 (Mar. 9, 2002), *codified in* I.R.C. § 448(d)(5), discussed in J. Salles, "Tax Accounting," 3(11) *Corp. Bus. Tax'n Monthly* 28, 28-29 (August 2002).

27. 1971-2 C.B. 549.

28. *See* Prop. Reg. § 1.468B-6 thru -9.

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