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IRS Rules that Deferred Compensation Distribution Paid to a Tax-Exempt Organization is Still Deductible by the Employer

The Internal Revenue Service released a private letter ruling (PLR 200905016) in which it held that a nonqualified deferred compensation payment payable to a tax-exempt charity would nevertheless be deductible by the employer.

Background

Private Letter Ruling (PLR) 200905016 involved a corporation that adopted a nonqualified deferred compensation plan for a group of highly compensated employees. The plan allows the employees to defer portions of their salary and incentive compensation. The deferred compensation is payable upon death, separation from service or termination of the plan. An employee is allowed to designate the beneficiaries to receive the deferred compensation in the event of his or her death.

One employee participating in the plan designated his spouse as his beneficiary if she survives him by at least 45 days and does not disclaim the deferred compensation. In any other event, however, the amount is payable to a section 501(c)(3) tax-exempt organization. Under the normal deduction rules for nonqualified deferred compensation (section 404(a)(5) of the Revenue Code); deferred compensation is only deductible by the employer in the taxable year in which the amount attributable to the contribution is includable in gross income of the employee. The IRS regulations recognize that the deduction is nevertheless available even if the employee excludes some or all of the compensation from gross income under certain specific exclusions (not applicable in this case). The Revenue Service stated in the PLR that those exclusions “illustrate” that contributions are considered includable in gross income of an employee for purposes of these deduction rules even if it is excluded from the gross income of the beneficiary.

The Service ultimately holds in this PLR that, if the spouse makes a qualified disclaimer with respect to the deferred compensation or predeceases the employee so that the section 501(c)(3) organization is the designated beneficiary of the deferred compensation, it will “not preclude” the deduction pursuant to section 404(a)(5) of the Code.

The ruling itself, at least in terms of its holding, is fairly unremarkable, although it does clarify the application of the deduction rules for nonqualified deferred compensation where the payment will not be taxable to the person who receives it. However, the more remarkable aspect of this private letter ruling concerns the analysis and various statements made by the IRS in reaching the holding.

As part of that analysis, the Service spends considerable time discussing the income with respect to decedent (IRD) rules of the Internal Revenue Code, as well as the rules in section 2518 on qualified disclaimers. Even though the IRS spends most of the ruling talking about these provisions, it does not directly link this discussion with the holding in the ruling. It is not clear why the Revenue Service embarked on this discussion, although one possibility is that it may have been trying to signal its views on the income tax treatment of these payments even though that was not part of the ruling request. AALU contacted a number of Service personnel to explore this issue but was unable to obtain a definitive response.

Under the IRD rules, if amounts that would otherwise be taxable income to a decedent if they were received by him or her before death are not so taxed before death, then those amounts are IRD and are includable as taxable income in the taxable year of the decedent's death or in the income of a beneficiary of the decedent who received the IRD. The IRS pointed out in the PLR that the IRD rules state that, if an estate or other person entitled to receive funds sells the right to those funds, then the fair market value of that right or the amount received upon the sale, whichever is greater, is includable in the gross income of the seller. The IRS then says, "Similarly, if such right is disposed of by gift, the fair market of the right at the time of the gift must be included in the gross income of the donor." This may be indicating the IRS view that either the estate or the surviving spouse (if a disclaimer is made) would have taxable income by reason of these funds going to charity.

As part of its discussion of the qualified disclaimer rules in section 2518, the Service notes those rules provide that, in the case of a qualified disclaimer of an interest in property, "Subtitle B" of the Code shall apply with respect to such interest as if the interest had never been transferred to the disclaiming person. However, Subtitle B only applies to estate and gift taxes and does not apply to income taxes. (While the IRS did not discuss it, if a person has a right to receive income and refuses to accept it, then, under the constructive receipt rules, that person may be taxable on that income). By pointing out that section 2518 applies for estate and gift tax purposes, the Revenue Service may be indicating that the concept of the section does not apply for income tax purposes. Although the Service does not definitively so state, it can reasonably be argued that either the spouse or the estate has taxable income by reason of the payment to the charity.

In the event that this *Washington Report* is also considered to be a "marketed opinion" within the meaning of the IRS guidance, then, as required by the IRS, please be further advised of the following:

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