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IRS MEMO SHEDS A LITTLE LIGHT ON DEDUCTIBLE CONTRIBUTIONS

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A recent IRS chief counsel memorandum (CCM) explains the two-pronged outlay-of-assets test that contributions to qualified retirement plans must satisfy to be deductible under Internal Revenue Code Section 404(a). A CCM isn't binding precedent but offers insight into IRS's positions on various tax issues.

OUTLAY-OF-ASSETS TEST

Under Section 404(a), whether a contribution to a qualified retirement plan is deductible depends in part on whether the contribution is a payment to the trust. Neither the Code nor the regulations define "payment" for this purpose. However, the Supreme Court applied an objective outlay-of-assets test to make this determination in *Don E. Williams Co. v. Commissioner*, 429 US 569 (1977). Analyzing that case and later decisions, the CCM identifies two prongs to the outlay-of-assets test:

- The employer must have a reduction of assets.
- The trust must be able to take full advantage of the contribution after it's made.

Facts and circumstances determine whether a contribution satisfies the test, and the CCM gives examples of the types of contributions that do or don't satisfy each prong.

Employer Has Reduction of Assets

To count as a deductible payment, a contribution must involve an outlay of cash or other property by the sponsor. Promissory notes and other promises to pay, even if fully secured and transferrable, are not sufficient. The employer's own publicly traded debt or the debt of another controlled group member also does not satisfy this prong, as these debt instruments are essentially the same as promissory notes. However, the CCM says the transfer of a third-party's promissory note held by the employer would meet the test, so the fair market value of the note would be deductible, assuming all 404(a) requirements are satisfied.

Employers can't circumvent this prong through book entries. Without a corresponding transfer of assets to the plan, designating a contribution owed to the plan as a debit on the employer's books and an accrual on

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the plan's books is not an actual payment, the CCM says. IRS also looks at how an employer's financial statements treat a contributed asset. If a contribution is treated as an employer asset or can't be treated solely as a plan asset, IRS could find no outlay of assets has occurred.

Trust Can Take Full Advantage

The employer can't retain significant control over the asset or impose significant restrictions on the trust's ability to use the asset. For instance, if an employer contributes property to a trust but limits the trust's ability to sell the property, the contribution may not meet the outlay-of-assets test. A contribution also may fail to meet this prong if the contribution has any of these characteristics:

- Is inaccessible to the trustee — for example, cash held in escrow
- Provides the employer a call or put option
- Places other constraints on the trustee's ability to transfer or use the asset, such as restrictions on transferring the asset to a third party or using the asset as security for a loan

RELATED RESOURCES

Non-Mercer Resources

- Chief Counsel Memorandum 201935011 (IRS, Aug. 30, 2019)
- *Don E. Williams Co. v. Commissioner*, 429 US 569 (1977)

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