Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:CIN:2:POSTF-150408-01
JJBoyle

date: NOV - 1 2001

to: LMSB Financial Products & Transactions Team
Manager 1914, Indianapolis
Attn: Financial Products Specialist Carlos Bastidas

from: Associate Area Counsel (LMSB/2), Cincinnati

subject: [redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum is submitted in response to Financial Products Specialist Carlos Bastidas' request for our views concerning potential arguments he seeks to raise in the above-referenced case to preclude the taxpayer's deferral of some $[redacted] in fees and earnings thereon between [redacted] and [redacted].

One of the arguments, concerning the taxpayer's constructive receipt of the income, was the subject of a prior memorandum that was prepared and submitted for review by LMSB counsel in Miami, Florida. In a Nondocketed Significant Advice Review Memorandum issued on May 24, 2001, the Office of Assistant Chief Counsel Income Tax & Accounting (CC:Dom:IT&A) rejected the constructive receipt argument but indicated that I.R.C. § 83 might provide an alternate theory of recovery. In this regard, the National Office requested that LMSB Counsel modify their advice to include a discussion of I.R.C. § 83, and direct the Examination Division to provide additional information in support of section 83.

ISSUES

1. Whether the Commissioner can change the taxpayer's method of accounting from the cash method to the accrual method because the taxpayer is ineligible under I.R.C. 448 to use the cash method since it is a partnership with gross receipts in excess of $5 million and/or a tax shelter and, alternatively, because the cash method does not clearly reflect the taxpayer's income.

2. Whether the deferred income and earnings are attributable to the taxpayer under the constructive receipt doctrine of I.R.C. § 451.

3. Whether the deferred income and earnings are attributable to the taxpayer under the tax benefits doctrine of I.R.C. § 83.

FACTS

[redacted] (the taxpayer or the partnership) is a Nevada general partnership that is under audit for the [redacted], [redacted], [redacted], and [redacted] taxable years.[1] The taxpayer was formed in [redacted], and has used the cash basis method of accounting since its formation. During the years at issue, the taxpayer's general partners were five S Corporations: (1) [redacted]; (2) [redacted]; (3) [redacted]; (4) [redacted]; and (5) [redacted]. The shareholders of [redacted], [redacted], [redacted], [redacted], and [redacted] were:

Partner	Partner's Stockholders
[redacted]	[redacted]

During the years at issue, the taxpayer was registered with the Commodities Futures Trading Commission (CFTC) as a commodity pool operator and commodity trading advisor, but the taxpayer was not registered as an investment advisor with the Securities and Exchange Commission. The taxpayer was the Commodity Trading Advisor (CTA) and trading advisor for [redacted] fund companies (collectively referred to as the Funds): (1) [redacted]

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[1] An audit of the [redacted] and [redacted] tax years was commenced on [redacted]. Subsequently, a no change letter was issued and the audit was closed. Approximately one week later, however, it was discovered that the taxpayer had deferred some $[redacted] in income in the years [redacted] though [redacted], and the taxpayer's audit was reopened. For the [redacted], [redacted], and [redacted] taxable years, the Service is relying upon the six year assessment period available under I.R.C. § 6229(c)(2). It is our understanding that the three year assessment period for [redacted] has been extended by consent from [redacted] to [redacted].

[redacted], formed [redacted]; (2) [redacted], formed [redacted]; (3) [redacted], formed [redacted]; and (4) [redacted], formed [redacted].

The Funds were managed by [redacted], an Illinois Limited Partnership. As relevant here, [redacted], [redacted], and [redacted] were the general partners of [redacted].[2] By the end of [redacted], the Funds had some $[redacted] in assets and more than [redacted] investors.[3]

The Funds' initial "Trading Advisor" was [redacted], a Nevada partnership that was formed in [redacted]. Like the taxpayer, [redacted] was registered with the Commodities Futures Trading Commission (CFTC) as a commodity pool operator and commodity trading advisor. [redacted], [redacted], and [redacted] were the general partners of [redacted]. For tax purposes, however, [redacted] used the accrual basis, rather than the cash basis, method of accounting.

On [redacted], [redacted] and [redacted] entered into an "Advisory Agreement," whereby [redacted] was to make trading decisions on behalf of [redacted]'s investors and to make investment decisions for [redacted] if shares were sold. In return, [redacted] was to receive quarterly incentive fees equal to [redacted] percent of [redacted]'s cumulative New Profit, as defined in the Advisory Agreement. The Advisory Agreement further required [redacted] to pay [redacted] percent of its incentive fees to [redacted]'s sponsor, or to such other entity as directed by the Fund.

On [redacted], [redacted] and [redacted] entered into an "Advisory Agreement," whereby [redacted] was to make trading decisions on behalf of investors in the purchase and sale of financial instruments and to make investment decisions for [redacted]

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[2] As of [redacted], [redacted], a Florida Partnership, was the general partner of [redacted]. The [redacted], the [redacted], and [redacted] were the general partners of [redacted]. The Trusts each had [redacted] percent interests in [redacted], and [redacted] had a [redacted] percent interest in [redacted].

[3] As of [redacted], [redacted] had [redacted] investors; [redacted] had [redacted] investors; and the [redacted] had [redacted] investors. [redacted]. was a holding company for the Funds and had only three investors -- [redacted], [redacted] and The [redacted] -- as of [redacted].

[redacted] if shares were sold. As set forth in the Advisory Agreement, [redacted] intended to offer its participating shares for sale to [redacted] and [redacted] (the [redacted]). [redacted] received all compensation with respect to [redacted] from the [redacted].

The taxpayer was formed in [redacted]. According to a document entitled "[redacted]" that was prepared by [redacted] in [redacted]:

> . . . [[redacted]] was formed as a cash basis tax reporting vehicle to enter into a deferred compensation agreement with [redacted] with respect to the [redacted] percent ([redacted]%) advisory fee on offshore earnings. [redacted] could not be used for this purpose because it had elected the accrual basis for tax purposes. The original general partners of [redacted] were the same as [redacted] ([redacted], [redacted] and [redacted]. [redacted] was added in [redacted] to allow [redacted] to defer his offshore commissions. [redacted] was added in_____[4] to allow [redacted] to defer his offshore commissions.
>
> The advisory fees earned and the earnings on the accumulated amounts are not includable in [redacted] until they are actually received. However commission payments made by [redacted] to [redacted] and [redacted] are currently deductible for federal income tax purposes, [sic.] The advisory fees, after allocation of expenses incurred by [redacted] and net commissions paid to [redacted] and [redacted], is presently allocated [redacted] percent ([redacted]%) to [redacted], [redacted] percent ([redacted]%) to [redacted], and [redacted] percent ([redacted]%) to [redacted] . . . [redacted] does not share in any item of economic or taxable income or loss.

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[4] This blank line appears in the "[redacted]."

On [redacted], the taxpayer assumed [redacted] rights and obligations under its Advisory Agreements with [redacted] and [redacted]. It is our understanding that the taxpayer subsequently entered into Advisory Agreements with [redacted] and [redacted], which provided for the payment of "incentive fees" to the taxpayer from those Funds. All of the various Advisory Agreements between the taxpayer and the Funds provided for payment to the taxpayer of "incentive fees" through [redacted].

On [redacted], a Deferred Compensation Agreement (DCA) was made between the taxpayer and [redacted]. On [redacted], a DCA was made between the taxpayer and [redacted]. Both DCAs provided for payment of all deferred compensation and earnings thereon within 30 days after the earlier of [redacted] or termination of the respective Advisory Agreement. On [redacted], both DCAs were amended by replacing [redacted] with [redacted]. The stated purpose for the amendment was to: "align the interests of the [taxpayer] with those of the investors in the [Funds] and to demonstrate to such investors the [taxpayer's] long term commitment to the [Funds]." On [redacted], the taxpayer entered into a DCA with the [redacted] entered, which similarly provided for the payment of deferrals and earnings within 30 days after the earlier of [redacted] or termination of the Advisory Agreement.[5]

Each DCA permitted the taxpayer, to defer receipt of all or a portion of the incentive fees payable to the taxpayer from each of the three Funds by filing an election with the director of each Fund before the first day of the year to which the election applied. The DCAs further stipulated that an election could not be changed or revoked by the taxpayer during the calendar year. Any deferred compensation was treated as if it were invested in participating shares of the Funds, with the taxpayer's right to receive payment of any deferred compensation was that of an unsecured creditor. The DCAs were subject to amendment or termination by the Funds at any time, with the taxpayer's consent.[6]

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[5] Our copies of the taxpayer's Deferred Compensation Agreements with [redacted] and [redacted] are not executed by a representative of or on behalf of the taxpayer.

[6] According to [redacted]'s sole shareholder, [redacted], the deferral arrangement was intended to placate investors in the Funds investors by demonstrating that the Funds' managers (the taxpayers partners) had their money at risk in the Funds.

For the years [redacted] through [redacted], the taxpayer's financial records reflect total deferred fees and earnings thereon in the respective amounts of $[redacted] and $[redacted], comprised as follows:

[redacted]

Year	Deferred Fees	Earnings	Total
[redacted]	[redacted]	[redacted]	[redacted]
TOTAL	$[redacted]	$[redacted]	$[redacted]

[redacted]

Year	Deferred Fees	Earnings	Total
[redacted]	$[redacted]	$[redacted]	$[redacted]
TOTAL	$[redacted]	$[redacted]	$[redacted]

[redacted]

Year	Deferred Fees	Earnings	Total
[redacted]	$[redacted]	$[redacted]	$[redacted]
TOTAL	$[redacted]	$[redacted]	$[redacted]

In response to Information Document Requests (IDRs), the taxpayer provided information evidencing its election to defer payment of incentive fees only with respect to the following Funds for the following years:

Date of Election	Fund	Deferral Year
[redacted]	[redacted]	[redacted] and [redacted]

On [redacted], the taxpayer revoked its [redacted] election to defer payment of incentive fees from both [redacted] and [redacted] for the fourth quarter of [redacted]. Otherwise, despite your requests, the taxpayer has provided no records showing when, if, or how the taxpayer elected to defer the payment of any incentive fees due from [redacted] in the year [redacted] or from [redacted] in the years [redacted], [redacted] and [redacted].

The taxpayer did not include any incentive fees or earnings as income from any of the Funds on its [redacted], [redacted], and [redacted] income tax returns (Forms 1065). Moreover, the taxpayer neither excluded any deferred fees or earnings from income nor disclosed any of the deferral and/or earnings arrangements on its [redacted], [redacted], and [redacted] income tax returns. For [redacted], the taxpayer did report incentive fees of $[redacted], as a result of the revocation of its election for the fourth quarter of [redacted]. Thus, for the years [redacted] through [redacted], the taxpayer reported total net income of $[redacted], as follows:

	[redacted]	[redacted]	[redacted]	[redacted]
Gross Receipts	$[redacted]	$[redacted]	$[redacted]	$[redacted]
Incentive Fees	[redacted]	[redacted]	[redacted]	[redacted]
Other Income	[redacted]	[redacted]	[redacted]	[redacted]
Total Income	[redacted]	[redacted]	[redacted]	[redacted]
Total Expenses	[redacted]	[redacted]	[redacted]	[redacted]
Net Income	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted][7]

DISCUSSION

In your Form 886-A, you rely on the following four arguments to increase the taxpayer's taxable income by the deferred amounts and earnings thereon in each year: (1) the taxpayer should be put on the accrual method of accounting because it is a partnership with gross receipts in excess of $5 million and also a tax shelter and therefore ineligible under I.R.C. 448 to use the cash method of accounting; (2) alternatively, the taxpayer should be put on the accrual method because the cash method does not clearly reflect the taxpayer's income; (3) all of the deferred income and earnings is attributable to the taxpayer as income under the constructive receipt doctrine of I.R.C. § 451; and (4)

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[7] The bulk of the taxpayer's reported income in [redacted], [redacted] and [redacted] consisted of transfers to the taxpayer from [redacted] for expenses, mainly commissions payments, that [redacted] was obligated to pay the taxpayer. In [redacted], [redacted], [redacted], and [redacted], the taxpayer claimed commission expenses in the respective amounts of $[redacted], $[redacted], $[redacted], and $[redacted].

all of the deferred income and earnings is attributable to the taxpayer as income under the tax benefits doctrine of I.R.C. § 83. Each of these arguments is separately analyzed below.

1. The taxpayer's method of accounting may be changed from the cash method to the accrual method because the taxpayer is precluded from using the cash method by I.R.C. § 448.

A taxpayer is generally free to adopt any method of accounting that clearly reflects income. Treas. Reg § 1.446-1(a)(2). A taxpayer's accounting method clearly reflects income if it results in accurately reported taxable income under a recognized method of accounting. Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352, 354 (1st Cir. 1970); Hospital Corp. of America v. Commissioner, T.C. Memo. 1996-105.

I.R.C. § 446(b) vests the Commissioner with broad discretion in determining whether a particular method of accounting clearly reflects income. Knight-Ridder Newspapers v. United States, 743 F.2d 781, 788 (11th Cir. 1984). And, the Commissioner's determination in this regard will not be set aside unless it is "clearly unlawful" or "plainly arbitrary." Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532-533 (1979); RCMP Enterprises, Inc. v. Commissioner, 114 T.C. 211 (2000). The Commissioner may not, however, require a taxpayer to change from an accounting method that clearly reflects income to an alternate method of accounting merely because the Commissioner considers the alternate method to more clearly reflect the taxpayer's income. See Ansley-Sheppard-Burgess Co. v. Commissioner, 104 T.C. 367, 371 (1995).

I.R.C. § 448(a) generally precludes the use of the cash receipts and disbursements method of accounting by: (1) C corporations with gross receipts of $5 million or more; (2) partnerships that have a C corporation as a partner and gross receipts of $5 million or more; and (3) tax shelters as defined by reference to I.R.C. § 461(i)(3).[8]

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[8] This general rule does not apply to any farming business or qualified personal service corporations. Section 448 does not affect the application of any other provision of the Internal Revenue Code that would otherwise limit the use of the cash method of accounting. Nor does section 448 affect the authority of the IRS to require the use of the accounting method that clearly reflects income or the requirement that the taxpayer secure the consent of the IRS before changing its accounting

Section 461(i)(3)(A) through (C) defines a "tax shelter" as:

> (A) any enterprise (other than a C corporation) if at anytime interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale,
>
> (B) any syndicate (within the meaning of section 1256(e)(3)(B))[9], and
>
> (C) any tax shelter (as defined in section 6662(d)(2)(C)...).[10]

For transactions entered into prior to August 5, 1997, a "tax shelter" for purposes of section 6662(d) was defined as: (1) a partnership or other entity (such as a corporation or a trust); (2) any investment plan or arrangement; or (3) any other plan or arrangement, the principal purpose of which is the avoidance or evasion of federal income tax.[11] See Treas. Reg. § 6662-4(g)(2)(i).

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method. For example, a taxpayer may be required to change to an accrual method of accounting under section 446(b) because such method clearly reflects that taxpayer's income, even though the taxpayer is not prohibited by section 448 from using the cash method. Temp. Treas. Reg. § 1.448-1T(c).

[9] Section 1256(e)(3)(B) defines a syndicate as "any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity are allocable to limited partners or a limited entrepreneur (within the meaning of section 464(e)(2)).

[10] Pub. L. No. 103-465, § 744(a) amended section 6662(d)(2)(C) by redesignating clause(ii) as clause (iii) for transactions occurring after December 8, 1994. Pub. L. No. 104-188, § 1704(t)(78) subsequently amended I.R.C. 461(i)(3)(C) by striking "section 6662(d)(2)(C)(ii)" and inserting "section 6662(d)(2)(C)(iii)," effective August 20, 1996.

[11] For transactions entered into after August 5, 1997, the language of I.R.C. § 6662(d)(C)(2)(iii) was amended by changing "principal purpose" to "significant purpose." See Section 1028(c)(2) of the Taxpayer Relief Act of 1997 (Pub. L. No.105-34).

The "principal purpose" of an entity, plan, or arrangement is to avoid or evade federal income tax if that purpose outweighs any other purpose. Tax shelters are typically transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, overvalued assets or asset with values subject to substantial uncertainty, certain nonrecourse financing, financing techniques that do not conform to standard business practices, or the mischaracterization of the substance of the transaction. The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter. Treas. Reg. § 1.6662-4(g)(2)(i).

Nevertheless, the principal purpose of an entity, plan, or arrangement is not tax avoidance if the purpose of the entity, plan, or arrangement is to take advantage of tax benefits consistent with the Code and congressional purpose, such as: (1) exclusions from income; (2) acceleration of deductions, (3) the purchase or holding of tax exempt obligations; (4) taking accelerated depreciation allowances; (5) taking the percentage depletion allowance; (6) deducting intangible drilling and development costs as expenses; (7) establishing a qualified retirement plan; (8) claiming the possession tax credit; or (9) electing to be taxed as a DISC, FSC, or an S corporation. Treas. Reg. § 1.6662-4(g)(2)(ii).

A. The taxpayer is not precluded from using the cash method because of its partnership status.

We cannot concur with your argument that the taxpayer is precluded from using the cash method because it is a partnership with gross receipts of $5 million or more. To be sure, the taxpayer is a partnership which appears to have average gross receipts in excess of $5 million. Nevertheless, section 448(a)(2) precludes the use of the cash method only with respect to "[a] partnership which has a C corporation as a partner." Since none of the taxpayer's four partners are C corporations, the taxpayer is not barred from using the cash method by virtue, of its partnership status.

B. The taxpayer is precluded from using the cash method because it is a tax shelter within the meaning of I.R.C. § 448.

As we see it, the only theory to preclude the taxpayer's use of the cash method of accounting is that the taxpayer is a tax shelter as defined in section 6662(d)(2)(C). With that said, however, this case presents a close question whether the deferral arrangements between the taxpayer and the Funds can be characterized as a tax shelter within the meaning of I.R.C. § 6662(d)(C)(2), to preclude the taxpayer's use of the cash basis method of accounting as a tax shelter under I.R.C. § 448(a). Nevertheless, as discussed below, we believe that taken in their totality the deferral arrangements can be characterized as a tax shelter for purposes of I.R.C. §§ 6662(d)(C)(2) and 448(a).

Based on the "[redacted]," there can be no serious dispute that the taxpayer was organized as a cash basis taxpayer for the principal purpose of deferring income and income tax liabilities for initially three, and ultimately eleven, years. The question then becomes whether the deferral of such income and tax is "tax avoidance."

On one hand, the internal revenue laws permit taxpayers in certain circumstances to legitimately defer income and the income tax thereon.[12] See I.R.C. § 451. On the other hand, the deferral of income is not among the tax benefits specifically cited in the regulations as examples of what is not tax avoidance for purposes of section 6662(d)(C)(2). Indeed, tax shelters are, by their nature, arrangements designed to defer income tax consequences, such as those in place here. See Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 197 (1983), aff'd in part, rev'd in part 752 F.2d 89 (4th Cir. 1985). Moreover, when the focus of this case is shifted from the taxpayer as an individual taxpaying entity to that of a participant in the deferral arrangements, the characteristics of a tax shelter become more pronounced. Under the deferral arrangements, the taxpayer of course benefitted from the time value of the deferred tax and the possibility of lower tax rates when the tax eventually became due, which is characteristic of a tax shelter. See Burdett v. Miller, 957 F.2d 1375, 1384 (7th Cir. 1992). Of

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[12] To the extent that the Deferred Compensation Agreements provide that the deferred incentive fees are subject to claims of the Funds' general creditors, the deferral arrangement resembles a Rabbi trust. Otherwise, however, the formalities necessary for a Rabbi trust have been ignored. See Rev. Proc. 92-64, 1992-2 C.B. 422.

course, the Funds were located in a tax haven country and benefitted through the influx of investment capital. Finally, the various partners benefitted in all respects since they both controlled the taxpayer and managed the Funds.

Other than tax avoidance, there was no legitimate business purpose to be achieved by the taxpayer through its creation and the deferral arrangements. Both the taxpayer and its predecessor, [redacted], were registered as commodity pool operators and commodity trading advisors, but neither was registered as an advisor with the Securities and Exchange Commission. Thus, the taxpayer was not more qualified to render advice to the Funds. The stated business purpose for the deferral of income was to stimulate investor confidence in the Funds by demonstrating that the managers had their own money at risk in the Funds. Except for the avoidance of tax, however, this purpose could just as effectively been achieved through the taxpayer's receipt and subsequent reinvestment of fees back into the Funds. In any event, in determining whether a partnership's transactions demonstrate a business purpose, the scope of the inquiry is limited to the business purpose of the partnership being audited. See, e.g., Brannen v. Commissioner, 722 F.2d 695, 703-704 (11th Cir. 1984). Thus, even assuming that the deferral arrangements had a legitimate business purpose, the deferral arrangements served the business purpose of the Funds, rather than the business purpose of the taxpayer.

In these circumstances, it is our opinion that the taxpayer's method of accounting can be changed from the cash method to the accrual method on the theory that the taxpayer is a tax shelter.

C. To the extent that the taxpayer is not a tax shelter, it is not otherwise precluded from using the cash method of accounting.

As noted, I.R.C. § 446(b) vests the Commissioner with broad discretion in determining whether a particular method of accounting clearly reflects income. Knight-Ridder Newspapers v. United States, 743 F.2d 781, 788 (11th Cir. 1984). Nevertheless, the Commissioner is not permitted to change a taxpayer's method of accounting to an alternate method of accounting merely because the Commissioner considers the alternate method to more clearly reflect the taxpayer's income. See Ansley-Sheppard-Burgess Co. v. Commissioner, 104 T.C. at 371.

To the extent that the taxpayer cannot be characterized as a tax shelter for purposes of section 448, we see no basis for changing the taxpayer's method of accounting from the cash method to the accrual method.

2. **Of the total $[redacted] in deferred fees and earnings during the years [redacted] through [redacted], $[redacted] is taxable as income to the taxpayer in the years [redacted] through [redacted] under the constructive receipt doctrine.**

As indicated, Income Tax & Accounting previously rejected the argument that all deferred fees and earnings are taxable, and we do not intend to challenge that conclusion. Nevertheless, based on our review of the facts, it appears that the taxpayer failed to make an election to defer the payment of $[redacted] in incentive fees and earnings from [redacted] and [redacted] for the years [redacted] through [redacted]. The fact and consequences of the taxpayer's failure to make a deferral election with respect to that amount were neither considered nor addressed previously.

The constructive-receipt doctrine requires a taxpayer that is on the cash method of accounting to recognize income when the taxpayer has an unqualified vested right to receive immediate payment of income. Amend v. Commissioner, 13 T.C. 178, 185 (1949); Martin v. Commissioner, 96 T.C. 814, 823 (1991); Palmer v. Commissioner, T.C. Memo. 2000-228. Under that doctrine a taxpayer may not deliberately turn its back on income otherwise available. Martin v. Commissioner, 96 T.C. at 823. In order to trigger application of the constructive receipt doctrine, there generally must be an amount that is due and owing which the obligor is ready, willing, and able to pay. Childs v. Commissioner, 103 T.C. 634, 654 (1994), aff'd without published opinion 89 F.3d 856 (11th Cir. 1996).

If a taxpayer has entered into a binding contract or agreement to defer income before it is earned, the income is not includable in income by a cash basis taxpayer until it is received. Robinson v. Commissioner, 44 T.C. 20 (1965); Martin v. Commissioner, 96 T.C. at 823. It has also been held that the constructive-receipt doctrine does not apply where the taxpayer elects to further defer income by entering into a superceding contract so long as the amounts are not yet due. Veit v. Commissioner, 8 T.C. 809, 818 (1947); Martin v. Commissioner, 96 T.C. at 824.

In order to defer compensation in accordance with each of the three Deferred Compensation Agreements, the taxpayer was required to file an election with the director of each Fund before the first day of the year to which the election applied. Based on information provided by the taxpayer, such elections were made only with respect to: (1) [redacted] for the years [redacted], and [redacted]; (2) [redacted] for the year [redacted]; and (3) the [redacted] for the years [redacted] and [redacted]. The taxpayer failed to provide any information to support the making of any election to defer income with respect to [redacted] for the year [redacted] or [redacted] for the years [redacted], and [redacted]. Yet during those years, the taxpayer earned $[redacted] in incentive fees and $[redacted] in earnings from the Funds, as follows:

[redacted]

Year	Deferred Fees	Earnings	Total
[redacted]	$[redacted]	$[redacted]	$[redacted][13]

[redacted]

Year	Deferred Fees	Earnings	Total
[redacted]	$[redacted]	$[redacted]	$[redacted]
TOTAL	$[redacted]	$[redacted]	$[redacted]

The taxpayer failed to elect to defer payment of that income before it was earned, as required by the respective Deferred Compensation Agreements, and the Funds had some $[redacted] in assets. Thus, the taxpayer is liable under the constructive-receipt doctrine for the payment of tax on that income reflected above since it was due and owing to the taxpayer and payable by the Funds.

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[13] For the year [redacted], the taxpayer also deferred $[redacted] in incentive fees [redacted] and earnings [redacted] from [redacted]. No election was filed with respect to those deferrals, but it is our understanding that [redacted] is not a year under audit.

3. The deferred income and earnings cannot be attributed to the taxpayer under the tax benefits doctrine of I.R.C. § 83.

I.R.C. § 83 provides that if property is transferred to any person in connection with the performance of services, the person who performed the services is required to include in income the fair market value of such property (less any amounts which were paid for such property) in the first taxable year in which such property becomes transferable or is not subject to a substantial risk of forfeiture, whichever comes first. According to Treas. Reg. § 1.83-3(a)(1), a "transfer" occurs when a service provider "acquires a beneficial interest in" property.

For purposes of section 83, the term "property" includes real and personal property other than money or an unfunded and unsecured promise to pay money or property in the future. Property also includes a beneficial interest in assets (including money) transferred or set aside from claims of the transferor's creditor's, for example in a trust or escrow account. Treas. Reg. § 1.83-3(e). Thus, for something not to be considered "property" for purposes of section 83, it must be subject to the claims of the service recipient's creditors.

A substantial risk of forfeiture is a condition that the service recipient imposes on the service provider, not something that the service provider freely elects in order to obtain the privilege of a tax deferral. Richardson v. Commissioner, 64 T.C. 621 (1975). Section 83(c)(1) provides that a service provider's rights in property are subject to a substantial risk of forfeiture if his rights to full enjoyment of the property are conditioned on the future performance of substantial services by him. A risk of forfeiture is substantial if there is a real risk and high probability that forfeiture will occur if the contractual conditions are not satisfied. Robinson v. Commissioner, 805 F.2d 38 (1st Cir. 1985). The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture. Treas. Reg. § 1.83-3(c)(1).

Based on the Deferred Compensation Agreements, the taxpayer acquired an ownership interest in the respective Fund's shares equal to the amount of the deferred fees. Other than a risk that the shares would decline in value prior to the [redacted] payment date, there was no substantial risk of forfeiture. Nevertheless, under the terms of each DCA the taxpayer's shares in each Fund were subject to the claims of the Fund's creditors. Thus, the shares do not constitute "property" for purposes of section 83. While it might be argued that the shares are not

reachable by creditors as a practical matter because they are located in a bank secrecy jurisdiction, there is no authority to support such an argument at this point. Thus, section 83 appears to be inapplicable here.[14]

Please contact the undersigned at (513) 263-4856 if you have any questions or concerns regarding this memorandum.

MATTHEW J. FRITZ
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(Large and Mid-Size Business)

By:_____
JOHN J. BOYLE
Senior Attorney (LMSB)

cc: Area Counsel (Heavy Manufacturing, Construction and Transportation: Edison)

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[14] One commentator has recently suggested that the IRS should issue a revenue ruling to the effect that if the assets representing deferred compensation funds are located in a bank secrecy jurisdiction, they are not, as a practical matter, reachable by the service recipient's creditors, and those assets should be considered "property" under section 83. See Lee A. Sheppard, Moving Deferred Compensation Offshore, 2001 TNT 166-3 (August 24, 2001).