Albertson's, Inc. v. Commissioner, 95 T. C. 415 (1990)

Amounts designated as interest under nonqualified deferred compensation arrangements are not deductible as interest but as deferred compensation when included in the employee's income.

Summary

Albertson's, Inc. established nonqualified deferred compensation arrangements (DCAs) for key executives and a director, allowing them to defer compensation until retirement or termination. The agreements included an "interest" component calculated on the deferred amounts. Albertson's sought to deduct this "interest" as it accrued, arguing it constituted deductible interest under IRC section 163. The Tax Court held that these amounts were not interest but additional deferred compensation, deductible only when included in the employee's income per IRC section 404. This ruling ensures that employers cannot claim deductions for deferred compensation as interest, maintaining the integrity of tax deferral benefits for employees.

Facts

Albertson's, Inc. , an accrual basis taxpayer, established DCAs for eight key executives and one outside director. Under these DCAs, participants agreed to defer part of their future compensation until retirement, termination, or a specified age. Albertson's maintained bookkeeping accounts for each participant, calculating the deferred compensation plus an "interest" component based on the company's long-term borrowing rate or market rates. Albertson's sought to change its accounting method to deduct this "interest" as it accrued, which the IRS initially allowed but later retroactively revoked. Albertson's then challenged this revocation and the characterization of the "interest" as non-deductible deferred compensation.

Procedural History

Albertson's filed a petition with the U. S. Tax Court after receiving a notice of deficiency from the IRS. The court severed the issue of the IRS's retroactive revocation of Albertson's accounting method change, which Albertson's later conceded. The remaining issues involved whether the "interest" component of the DCAs was deductible as interest under IRC section 163 or as deferred compensation under IRC section 404. The Tax Court ultimately held that the "interest" was not deductible as interest but as deferred compensation.

Issue(s)

1. Whether the amounts designated as interest under Albertson's DCAs constitute "interest" within the meaning of IRC section 163.
2. If not interest under section 163, whether these amounts are deductible as deferred compensation under IRC section 404.

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Holding

1. No, because the “interest” component does not represent payments for the use of borrowed money or forbearance of a debt, but rather part of the total deferred compensation.
2. Yes, because these amounts are additional deferred compensation for personal services, deductible only when included in the employee’s gross income under IRC section 404.

Court’s Reasoning

The court reasoned that the “interest” component of the DCAs was not interest under IRC section 163 because it did not represent payments for the use of borrowed money or forbearance of a debt. The court emphasized that the DCA participants never had a legal right to the deferred compensation in the year services were performed, thus Albertson’s could not have “borrowed” the money. The court applied the economic substance over form doctrine, finding that the “interest” was an integral part of the deferred compensation calculation, not a separate interest payment. The court also considered the policy behind IRC section 404, which aims to ensure that deferred compensation benefits are actually received by employees before deductions are allowed. The majority opinion was supported by eight judges, with a concurring opinion and a dissenting opinion also filed.

Practical Implications

This decision has significant implications for employers using nonqualified deferred compensation plans. It clarifies that any “interest” component credited to deferred compensation accounts is not deductible as interest under IRC section 163 but as deferred compensation under IRC section 404 when included in the employee’s income. This ruling prevents employers from accelerating deductions by characterizing part of deferred compensation as interest, ensuring that the tax benefits of deferral align with the actual receipt of benefits by employees. Practitioners should advise clients to structure DCAs in compliance with this ruling, and to consider the impact on cash flow and tax planning. Subsequent cases, such as *Cohen v. Commissioner*, have reinforced this principle by distinguishing between actual interest and amounts calculated using interest rates for deferred compensation purposes.

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