

**Description of Revenue Offset in  
Amendment to H.R. 2621,  
the "Reciprocal Trade Agreement Authorities Act of 1997"  
as reported by the Committee on Ways and Means**

This document, prepared by the staff of the Joint Committee on Taxation, describes the revenue offset in an amendment to H.R. 2621, the "Reciprocal Trade Agreement Authorities Act of 1997," reported by the Committee on Ways and Means on October 23, 1997 (H. Rep. No. 105-341 Part I).

The provision in the amendment would substitute the following revenue-raising provision for section 301 of the bill as so reported.

**Employer Deductions for Severance Pay**

**Present Law**

For deduction purposes, any method or arrangement that has the effect of a plan deferring the receipt of compensation or other benefits for employees is treated as a deferred compensation plan (sec. 404(b)). In general, contributions under a deferred compensation plan (other than certain pension, profit-sharing and similar plans) are deductible in the taxable year in which an amount attributable to the contribution is includible in income. However, vacation pay which is treated as deferred compensation is deductible for the taxable year of the employer in which the vacation pay is paid to the employee (sec. 404(a)(5)).

Temporary Treasury regulations provide that a plan, method, or arrangement defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. A plan, method or arrangement is presumed to defer the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the 3rd calendar month after the end of the employer's taxable year in which the related services are rendered (the "2-1/2 month" period). A plan, method or arrangement is not considered to defer the receipt of compensation or benefits for more than a brief period of time after the end of the employer's taxable year to the extent that compensation or benefits are received by the employee on or before the end of the applicable 2-1/2 month period. (Temp. Treas. Reg. Sec. 1.404(b)-1T A-2.)

The Tax Court recently addressed the issue of when vacation pay and severance pay are considered deferred compensation in Schmidt Baking Co. Inc., 107 T.C. 271 (1996). In Schmidt Baking, the taxpayer was an accrual basis taxpayer with a fiscal year that ended

December 28, 1991. The taxpayer funded its accrued vacation and severance pay liabilities for 1991 by purchasing an irrevocable letter of credit on March 13, 1992. The parties stipulated that the letter of credit represented a transfer of substantially vested interest in property to employees for purposes of section 83, and that the fair market value of such interest was includible in the employees' gross incomes for 1992 as a result of the transfer.<sup>1</sup> The Tax Court held that the purchase of the letter of credit, and the resulting income inclusion, constituted payment of the vacation and severance pay within the 2-1/2 month period. Thus, the vacation and severance pay were treated as received by the employees within the 2-1/2 month period and were not treated as deferred compensation. The vacation pay and severance pay were deductible by the taxpayer for its 1991 fiscal year pursuant to its normal accrual method of accounting.

### **Description of Proposal**

The proposal provides that, for purposes of determining whether severance pay<sup>2</sup> is deferred compensation (under Code sec. 404), the severance pay is not considered to be paid or received until actually received by the employee. In addition, severance pay is not considered paid to an employee until actually received by the employee. The proposal is intended to overrule the result in Schmidt Baking. For example, with respect to the determination of whether severance pay is deferred compensation, the fact that the value of the severance pay is includible in the income of employees within the applicable 2-1/2 month period is not relevant. Rather, the severance pay must have been actually received by employees within the 2-1/2 month period in order for the compensation not to be treated as deferred compensation.

It is intended that similar arrangements, in addition to the letter of credit approach used in Schmidt Baking, do not constitute actual receipt by the employee, even if there is an income inclusion. Thus, for example, actual receipt does not include the furnishing of a note or letter or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument or by any third party. As a further example, actual receipt does not include a promise of the taxpayer to provide service or property in the future (whether or not the promise is evidenced by a contract or other written agreement). In addition, actual receipt does not include an amount transferred as a loan, refundable deposit, or contingent payment. Amounts set aside in a trust for employees generally are not considered to be actually received by the employee.

The proposal does not change the rule under which deferred compensation (other than vacation pay and deferred compensation under qualified plans) is deductible in the year

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<sup>1</sup> While the rules of section 83 may govern the income inclusion, section 404 governs the deduction if the amount involved is deferred compensation.

<sup>2</sup> A provision that overrules Schmidt Baking with respect to vacation pay and compensation other than severance pay is included in the Internal Revenue Service Restructuring and Reform Act of 1997, as passed by the House on November 6, 1997.

includible in the gross income of employees participating in the plan if separate accounts are maintained for each employee.

While Schmidt Baking involved only vacation pay and severance pay, there is concern that this type of arrangement may be tried to circumvent other provisions of the Code where payment is required in order for a deduction to occur. Thus, it is intended that the Secretary will prevent the use of similar arrangements. No inference is intended that the result in Schmidt Baking is present law beyond its immediate facts or that the use of similar arrangements is permitted under present law.

The proposal does not affect the determination of whether an item is includible in income. Thus, for example, using the mechanism in Schmidt Baking for vacation pay would still result in income inclusion to the employees, but the employer would not be entitled to a deduction for the vacation pay until actually paid to and received by the employees.

#### **Effective Date**

The provision is effective for taxable years ending after October 8, 1997. Any change in method of accounting required by the proposal will be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment required by section 481 as a result of the change will be taken into account in the year of the change.