

**REVENUE OFFSET FOR
U.S. CARIBBEAN BASIN TRADE PARTNERSHIP ACT**

**(Scheduled for Markup by the House Committee
on Ways and Means
on October 9, 1997)**

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.¹ 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 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 would specifically overrule the result in Schmidt Baking and provide that, with respect to severance pay,² the Internal Revenue Code will be applied without regard to the result reached in that case. Thus, under the proposal, the fact that severance pay is includible income would not be taken into account in determining whether or not payment had been made. In determining whether severance pay is deferred compensation, the fact that it is includible in the income of employees within the applicable 2-1/2 month period would not be taken into account in determining whether there has been payment or receipt by the employees. Rather, the item must have been actually paid or received within the 2-1/2 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 payment of severance pay, even if employees have an income inclusion. Thus, for example, payment would 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, payment would 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, payment would not include an amount transferred as a loan, refundable deposit, or contingent payment.

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 severance pay would still result in income inclusion to the employees, but the employer would not be entitled to a deduction for the severance pay until actually paid to and received by the employees.

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

² The Committee on Ways and Means is separately marking up a proposal that would overrule Schmidt Baking other than with respect to severance pay.

Effective Date

The proposal would be effective for taxable years ending after October 8, 1997. Any change in method of accounting required by the proposal would 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 would be taken into account in the year of the change.