



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel (Employee Benefits and Exempt Organizations)
CC:ECEO

SUBJECT:

This Field Service Advice follows up our telephone conversation on November 18, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer =

Year A =

Year B =

Year C =

Year D =

Year E =

The Appendix to this memorandum sets out language as we discussed for your use in preparing a notice of proposed adjustments with respect to the above-

referenced Taxpayer. If you have any further questions or would like to discuss the issues further, please feel free to call us at (202) 622-6060.

MARY E. OPPENHEIMER
Assistant Chief Counsel

By: _____
MARK SCHWIMMER
Chief, Branch 4
Office of the Associate Chief Counsel
(Employee Benefits and Exempt
Organizations)

APPENDIX

ISSUE: Whether Taxpayer may deduct vacation pay in the taxable year it accrued, when Taxpayer did not make a contribution to the Trust to fund the vacation pay until the following year.

* * *

The deductions claimed in the amounts of \$[insert each year's contribution amount] for contributions to the Trust for the Year A, Year B, Year C, and Year D tax years are disallowed for the following reasons.

Section 162(a) of the Code provides for a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Regulation § 1.162-10(a) provides that amounts paid or accrued within the taxable year for vacations are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business. However, temporary regulation § 1.162-10T, Q&A 2 provides that section 419 governs the deduction of contributions paid or accrued by an employer with respect to a "welfare benefit fund" (within the meaning of section 419(e)). Section 419(a) of the Code provides that contributions paid or accrued by an employer to a welfare benefit fund shall not be deductible under Chapter 1 of the Code, but if they would otherwise be deductible, are deductible to the extent of qualified costs under section 419 for the taxable year in which paid.

The Trust constitutes a welfare benefit fund as defined in section 419(e). First, the Trust is a fund under section 419(e)(3)(B) because it is a non-exempt trust. Second, the vacation pay benefits provided by Taxpayer to its employees through the Trust are welfare benefits under section 419(e)(2). Section 419(e)(2) defines "welfare benefit" as any benefit other than a benefit with respect to which the following apply: (A) section 83(h), (B) section 404 (determined without regard to section 404(b)(2)), or (C) section 404A. Section 404A, which applies to foreign deferred compensation plans, is not applicable in this case.

Section 83(h) of the Code provides that in the case of a transfer of property to which section 83(a) applies, there is allowed as a deduction under section 162, to the person for whom the services were performed, an amount equal to the amount included under section 83(a) in the gross income of the person who performed the services. This deduction is generally allowed to the service recipient for the taxable year in which or with which ends the taxable year in which the amount is included as compensation by the person who performed the services. Under §1.83-6(a)(3) of the regulations, however, in the case of a transfer to an employee benefit plan described in § 1.162-10(a), section 83(h) does not apply. Since the contributions in

issue were made to Trust, which holds assets of the vacation plan (an employee benefit plan), section 83(h) is not applicable.

To the extent that the vacation pay benefits could be viewed as "deferred benefits (other than compensation)" that would be treated as deferred compensation under section 404(b)(2)(A), they are nevertheless treated as welfare benefits under section 419(e)(2) because they are not within the exception under section 419(e)(2)(B) for benefits to which section 404 applies. They are not within that exception because the reference in section 419(e)(2)(B) to section 404 is to "section 404 (determined without regard to section 404(b)(2))".

Applying the rules under section 419, each contribution by Taxpayer to the Trust is not deductible before the year in which it was paid to the Trust. Rather, it is deductible in the taxable year in which it was paid to the Trust, to the extent of the Trust's qualified cost for that year. Since vacation pay is not a reservable benefit under section 419A(a), the qualified cost for vacation pay is the aggregate amount (including administrative expenses) that would have been allowable as a deduction to Taxpayer with respect to benefits provided during that year, if such benefits were provided directly by Taxpayer and Taxpayer used the cash receipts and disbursements method of accounting. Section 419(c)(3)(A).

Thus, Taxpayer's contribution to the Trust in March of Year B is deductible in Year B under sections 419 and 419A rather than in Year A because it was not paid during Year A. Section 419(a)(2). Likewise, Taxpayer's contributions to the Trust in Years C, D, and E are deductible in years C, D, and E, respectively, rather than in years B, C, and D.

Taxpayer's argument (based upon the legislative history of the repeal of Code section 463 and amendment of section 404(a)(5) by the Omnibus Budget Reconciliation Act of 1987, Pub. L. 100-203 (OBRA 1987)) that section 419 does not apply to contributions to a trust to fund vacation pay amounts, but rather the timing of the deduction for such contributions should be governed by the "2-1/2 month rule" contained in temporary regulation § 1.404(b)-1T, is not supported by the statute. Section 463 of the Code provided special rules under which a taxpayer could elect to deduct vacation pay for years prior to 1987. Prior to the OBRA 1987 amendments, section 419(e)(2)(D) provided for an exception to the application of section 419 for benefits with respect to which an election under section 463 applied. The only amendment made by OBRA 1987 to section 419 removed the exception previously contained in section 419(e)(2)(D). See OBRA 1987, section 10201(b)(4). In the absence of that exception, the plain language of section 419 governs the timing of deductions with respect to contributions to a welfare benefit fund (such as the Trust) to fund vacation pay benefits such as those provided to Taxpayer's employees. A committee report describing the effect of the

repeal of an exception to section 419 cannot override the plain meaning of the Code.

Application of section 419 in this case is consistent with congressional intent in enacting section 419, to prohibit employers from claiming deductions for nonreservable benefits (i.e., benefits other than disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits) prior to the time the benefits are provided to employees, and are included in the employees' gross income (or would be included in the employees' gross income but for a provision excluding benefits from gross income). See generally, H.R. Rep. No. 98-432 (Pt 2), 98th Cong., 2d Sess.(1984), at 1275-1278.