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From:
Sent: Friday, June 04, 2010 3:11:51 PM
To:
Cc:
Subject: Continuous Audit Program (CAP) case

Regarding your CAP case question on section 419:

Taxpayer =
Year 1 =
Year 2 =
X =
Market =
Date 1=
Date 2=
Consultants =

Taxpayer is an accrual basis fiscal year taxpayer. Taxpayer pays severance benefits in its discretion on an ad hoc basis, and vacation benefits pursuant to its established policy. Historically, Taxpayer has paid both severance and vacation pay from its general assets. Due to a decline in the Market over the past few years, Taxpayer has paid significant severance and expects to continue to pay additional severance over the next few years. Effective Date 1, Taxpayer established Trust to pay this anticipated severance and vacation pay. Trust intends to submit an application for recognition of exempt status in Year 2. On Date 1, Taxpayer contributed over $ X to the Trust and deducted that amount on its tax return for Year 1. Taxpayer indicates that beginning Date 2, Taxpayer will make payments for vacation and severance and will seek reimbursement from the Trust.

Taxpayer computed the amount deducted based on the limitation set forth in section 419A(c)(5). Taxpayer has not provided any information documenting any severance claims incurred in Year 1 that it expects to pay in Year 2. Taxpayer indicates that because the Trust was established “to pay severance that they anticipate they will have to pay over the next few years…”, and because the amount deducted is within the limit set forth in section 419A(c)(5)(B)(iii), that the deduction is proper. A memorandum provided to Taxpayer by Consultants further indicates it can use amounts in the Trust for other benefits, including vacation pay.

Law and Legislative History

Under 419(a), Contributions paid or accrued by an employer to a welfare benefit fund, if otherwise deductible, are deductible under section 419 in the year in which paid. The Trust is a welfare benefit fund. Under section 419(b), the deduction is limited to the Trust's qualified cost for the taxable year. Under section 419(c)(1), "qualified cost" means, with respect to any taxable year, the sum of (A) qualified direct cost for such taxable year and, (B) subject to 419A(b), any addition to a qualified asset account for the taxable year. Under section 419(c)(2), the qualified cost is reduced by the fund's after tax income for the taxable year.

Under section 419(c)(3)(A), qualified direct cost means, with respect to any taxable year, the aggregate amount (including administrative expenses) which would have been allowable as a deduction to the employer with respect to the benefits provided during the a taxable year, if (i) such benefits were provided directly by the employer, and (ii) the employer used the cash receipts and disbursements method of accounting.

Section 419A(a) defines the term "qualified asset account" to mean any account set aside to provide for payment of disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits.

Section 419A(b) states that no addition to any qualified asset account may be taken into account under section 419(c)(1)(B) to the extent such addition results in the amount in such account exceeding the account limit.

Section 419A(c)(1) provides that, except as otherwise provided in section 419A(c), the account limit for any qualified asset account for any taxable year is the amount reasonably and actuarially necessary to fund –(A) claims incurred but unpaid (as of the close of such taxable year) for benefits referred to in subsection (a), and (B) administrative costs with respect to such claims.

Section 419A(c)(5)(A) provides that unless there is an actuarial certification of the account limit for any taxable year, the account limit shall not exceed the sum of the safe harbor limits for the taxable year. Section 419A(c)(5)(B) sets forth "Safe Harbor Limits" for the various types of reservable benefits. Section 419A(c)(5)(B)(iii) provides that in the case of SUB or severance pay benefits, the safe harbor limit for any taxable year is the amount determined under paragraph 419A(c)(3). Section 419A(c)(3)(A) provides that the account limit for any taxable year with respect to SUB or severance pay benefits is 75 percent of the average annual qualified direct costs for SUB or severance pay benefits for any 2 of the immediately preceding 7 taxable years (as selected by the fund).

The legislative history of section 419 specifically states, "Even if the safe harbors are satisfied, the taxpayer is to show that the reserves, as allowed under the general standards provided by the bill (e.g., claims incurred but unpaid) are reasonable."

Conference Committee Report on the Deficit Reduction Act of 1984 (House Report 98-861) (the Conference Report) at 1158.

With respect to what is meant by "claims incurred", the Conference Report explains, "Claims are incurred only when an event entitling the employee to benefits, such as a medical expense, a separation, a disability, or a death actually occurs. The allowable reserve includes amounts for claims estimated to have been incurred but which have not yet been reported, as well as those claims which have been reported but have not yet been paid." Id at 1156.

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My Analysis and Conclusions

(1) Assuming the addition to the reserve is within the limit for severance benefits set forth in 419A(c)(5), Taxpayer is not required to have actuarial certification of the amount. However, section 419A(c)(5)(B)(iii) is not a "safe harbor" in the conventional sense. This section does not provide an alternative for determining the account limit, but rather the 75% limit is an upper limit on the amount that an employer may treat as an addition to a reserve for severance pay benefits without actuarial certification. See, e.g., General Signal, 103 T.C. 216 at 232 (1994), aff'd 142 F.3d 546 (2nd Cir. 1998) in which the Tax Court stated: "[s]ection 419A(c)(5)(B) does not allow a taxpayer to automatically claim 35 percent of its prior year's qualified direct costs as the amount of incurred but unpaid medical claims. Rather, the statute merely allows a taxpayer to claim amounts at or below this threshold without obtaining an actuarial certification." Sec. 419A(c)(5)(A)). The General Signal court cited H. Conf. Rept. 98-861, quoted above.

Thus, to deduct the amount contributed under section 419 in Year 1, Taxpayer must demonstrate that the amount contributed and deducted in Year 1 for severance benefits is not greater than the sum of qualified direct costs plus permitted additions to the qualified asset account, minus after-tax income of the fund. Accordingly, the amounts either had to be used for benefits paid in Year 1 (qualified direct costs), or be within the general limit for severance pay benefits under 419A(c)(1) of an amount reasonably and actuarially necessary to pay the claims incurred but unpaid as of the end of Year 1 (and therefore be a permitted addition to a qualified asset account under section 419A(c)(1)).

Whether an amount is reasonably and actuarially necessary to pay the claims incurred but unpaid as of the end of Year 1 is a determination that should be made based upon the particular facts and circumstances. Among factors to take into consideration is whether there is an established obligation to make severance payments for a fixed amount of time, or whether continuation of any severance payments is in the Taxpayer's discretion. According to the memo provided by Consultants, Taxpayer "pays severance benefits in its discretion and on an ad hoc basis". Accordingly, Taxpayer's employees do not have an automatic right to severance benefits if they are terminated. To establish that the severance benefits were "incurred" by the end of Year 1, at minimum,

Taxpayer would need to demonstrate that as of the end of Year 1, some of its employees had been terminated, and also demonstrate that it reasonably expected to pay severance benefits to those employees beyond Year 1. In any event, the amount of the deduction in Year 1 should not exceed amounts paid in severance benefits in Year 1 plus the amount that Taxpayer can demonstrate it reasonably expected, as of the end of Year 1, to pay beyond Year 1 in severance benefits for those terminated employees.

(2) The reserve for incurred but unpaid claims as of the end of Year 1 would not take into account benefits expected to be paid to employees who as of the end of Year 1 were still employed by Taxpayer. The reserve should not take into account any benefits for employees that were expected to be severed in Year 2 and beyond, because any severance claims for such employees were not "incurred" by the end of Year 1.

(3) The reserve must be intended to pay severance benefits, and use for vacation or other benefits (if the Trust is amended), particularly within a short period of time, would tend to negate Taxpayer's demonstration of intent. Cf, General Signal v. Comm'r, 142 F.3d 546 (2nd Cir. 1998), affirming 103 T.C. 216 at 232 (1994). (General Signal addressed whether the taxpayer established a reserve for postretirement medical benefits under section 419A(c)(2), and the Second Circuit said that depended upon the taxpayer's intent at the time the reserve was established. The Second Circuit explained, "Later depletions of a fund may serve as evidence of what a taxpayer's intent may have been…While our reading of the statute does not imply a commitment to establish funding through the working lives of covered employees, if subsequent events rendered maintenance of the reserve impossible, evidence of the reason for discontinuing or spending down the reserve could be presented in response to any accusation that a taxpayer never intended to be established in the first place.")