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Tax Regs in Plain English

IRS Restructuring and Reform Act of 1998

7001 - Clarification of Deduction for Deferred Compensation

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Section 7001

A. Provision(s) covered: Act section 7001, Clarification of Deduction for Deferred Compensation (overruling Schmidt Baking decision)

B. Background: Several years ago employers began using arrangements involving letters of credit to accelerate their deductions for vacation and severance pay. In challenging these arrangements, the Service lost *Schmidt Baking Co., Inc.*, 107 T.C. 271 (1996). The Tax Court held that the purchase of a letter of credit shortly after the end of the year in which the vacation pay was earned was sufficient to avoid the deferred compensation rules of section 404.

C. Change(s): The legislation overrules the result in *Schmidt Baking* (for both vacation pay and severance pay issues) by specifying that, for purposes of determining whether an item of compensation is deferred compensation under section 404, the compensation is not considered to be paid or received until actually received by the employee.

D. Impact: The legislation is prospective applying to tax years ending after date of enactment. Note, however, that the Conference Report includes the following statement with respect to prior years: "In light of the change being made and its effect on all cases involving this issue, the conferees ask the Secretary to consider whether, on a case-by-case basis, continued challenge of these arrangements for prior years represents

the best use of litigation resources.” The legislative history further indicates an expectation that the principles of the amendment will also be applied in other settings where the Code requires a payment in order for a deduction to occur.

E. Necessary Actions Actions/Procedures: It is anticipated that this area will be addressed in training and related materials on the new legislation. Our understanding is that handling of these cases will be done on a coordinated basis in order to ensure consistency in approach.

F. Other Special Comments: None

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