26 CFR 1.404(b)–1T: Method of contribution, etc., having the effect of a plan; effect of section 404(b). (Also Part I, sections 83(h), 404(a)(5), 404(a)(11), 404(b); 1.83–6, 1.162–10.)

Rev. Proc. 99–26

SECTION 1. PURPOSE

This revenue procedure provides alternative 50-percent settlement options to settle cases in which taxpayers accelerated deductions for accrued employee benefits secured by a letter of credit, bond, or other similar financial instrument. The purpose of this settlement initiative is to provide options for taxpayers and the Service to expeditiously resolve these cases, particularly in light of the recent legislative change that specifically precludes taxpayers from using these types of financial instruments to accelerate deductions for accrued employee benefits in the future. Settlement of these cases will relieve both taxpayers and the Service from the burdens associated with further development or litigation of the cases in the future.

SECTION 2. BACKGROUND

.01 Section 404(a)(5) and the regulations thereunder provide that deferred vacation pay is deductible in the taxable year in which it is paid to the employee and that other deferred benefits are deductible in the taxable year in which or with which ends the employee's taxable year in which the benefits are includible in gross income. (Special rules, not relevant to these cases, apply to compensation provided through a qualified plan or deferred benefits provided through a welfare benefit fund.)

.02 Section 1.404(b)–1T, Q&A-2 provides that compensation and benefits are considered deferred to the extent they are received by the employees more than 2½ months after the end of the employer's taxable year in which the related services are performed.

.03 Certain taxpayers have deducted for a taxable year the unpaid portion of accrued vacation pay and other benefits that the taxpayers secured during the first 2½ months of the following taxable year by purchasing a letter of credit, bond, or other similar financial instrument. Taxpayers argue that the securitization constitutes a transfer of property pursuant to § 83 and that this in turn constitutes receipt by the employees within the 2½-month period, thereby precluding the application of § 404. Accordingly, taxpayers argue that the timing of the deduction for the unpaid benefits secured by the letter of credit or other financial instrument is accelerated to the taxable year the benefits accrue, pursuant to the timing rules of § 83.

.04 In *Schmidt Baking Co. v. Commissioner,* 107 T.C. 271 (1996), the Tax Court addressed the application of the timing rules of §§ 83 and 404 to the securitization of vacation and severance pay benefits with an irrevocable standby letter of credit. The Tax Court held that the taxpayer was entitled to deduct the benefits under § 83 in the taxable year the benefits accrued. The Court concluded that a § 83 transfer of property constitutes receipt within the meaning § 404 and the regulations thereunder. Based upon the stipulation that the securitization of the benefits with the irrevocable letter of credit constituted a transfer of property under § 83, the Tax Court concluded that the benefits were received by the employees within the 2½-month period, so that the employer's deduction for the benefits was not subject to § 404. The Service has neither appealed nor acquiesced in that decision.

.05 Congress specifically overturned the decision in *Schmidt Baking* with the enactment of section 404(a)(11), which was added to the Code by § 7001 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA), Pub. L. No. 105–206, 112 Stat. 685, 827 (July 22, 1998). Section 404(a)(11) provides that, for purposes of determining under § 404 whether compensation of an employee is deferred compensation and when deferred compensation is paid, no amount is treated as received by the employee, or paid, until it is actually received by the employee. Section 404(a)(11) is effective for taxable years ending after July 22, 1998.

.06 The RRA provides that a taxpayer changing its method of accounting to comply with § 404(a)(11) for its first taxable year ending after July 22, 1998, will be treated as making a change initiated by the taxpayer with the consent of the Commissioner. It further provides that the change will be made with a § 481(a) adjustment that will be taken into account ratably over a 3-taxable-year period beginning with the first taxable year ending after July 22, 1998.

.07 The House and Senate committee reports on § 404(a)(11) state that "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." H. Rep. No 364, 105th Cong. 1st Sess. 87, 89 (1997); S. Rep. No. 175, 105th Cong. 2nd Sess.118, 120 (1998).

.08 The Conference committee report on § 404(a)(11) suggests that the Service consider "on a case-by-case basis [whether the] continued challenge of these arrangements for prior years represents the best use of litigation resources." H. Rep.No. 599, 105th Cong. 2nd Sess. 342, 345 (1998).

.09 In Notice 99–16, 1999–13 I.R.B. 10, the Service provided procedures for taxpayers to change their method of accounting for their first taxable year ending after July 22, 1998, to comply with § 404(a)(11). The Service withheld audit protection in connection with the change, thereby preserving the right to challenge these arrangements for prior taxable years.

.10 The Service has continued to examine cases involving these securitization arrangements and has concluded that, in general, they lack sufficient nontax business purpose and economic substance to be respected for tax purposes. Although the Service agreed to stipulate in *Schmidt* that, for purposes of that litigation, a "transfer of property" occurred under the rules of § 83, a review of the facts of other cases has led the Service to conclude that such a stipulation would not correctly reflect the facts of those cases. The Service reached that conclusion because, although the employees whose benefits were secured were thereby given certain legal rights, those rights were of such minimal significance that there was no sufficiently meaningful change in the parties' relationships to support the conclusion that the arrangements rose to the level of transfers of property under § 83. Accordingly, in the majority of cases, the Service has proposed to disallow the accelerated deductions attributable to the arrangements. Compare Revenue Ruling 99–14, 1999–13 I.R.B. 3.

.11 Disallowance of the accelerated deductions on the basis of those doctrines will be pursued, wherever appropriate. This analysis requires the Service to evaluate the facts and circumstances of each case with respect to business purpose and economic substance. Additional field work may be required by examiners to more fully develop the issue, particularly with regard to the taxpayer's nontax business purpose for entering into the arrangement. This may include, but would not be limited to, contact with third parties (such as the pertinent financial institutions, employees, former employees, corporate officers, escrow agents etc.); the use of depositions, summonses, etc., to obtain all relevant testimony and documentation pertaining to the implementation of the arrangement (including, but not limited to, any promotional materials, legal opinions regarding the tax consequences of the arrangement, etc.); and any other techniques deemed appropriate in order to fully establish the purpose for entering into the arrangement and to clarify the factors that may establish sufficient economic substance to the transactions.

.12 Absent an exception, FICA taxes must be deposited within specified times after wages are actually or constructively paid. No exception applies to these securitization arrangements. Therefore, if the Service examines a case and determines that the arrangement should be respected for tax purposes, the Service will assert the 10-percent failure-to-deposit penalty under § 6656 for taxpayers who have failed to timely deposit the employer's share of the FICA taxes.

SECTION 3. DEFINITIONS

.01 *Accelerated deduction.* The accelerated deduction for a taxable year is the amount of benefits accrued by the taxpayer for the taxable year that became secured during the first 2½ months after the end of that taxable year but were not actually received by its employees within that 2½-month period.

.02 *Excess accelerated deduction.* The excess accelerated deduction for a taxable year is the accelerated deduction for the taxable year less the amount of the accelerated deductions for prior taxable years that were actually received by employees during the taxable year (if vacation pay) or during the employees' taxable year ending with or within the taxable year (if benefits other than vacation pay). However, the excess accelerated deduction for the first taxable year covered by a settlement under this revenue procedure is equal to the accelerated deduction for the taxable year.

SECTION 4. SCOPE

.01 *In general.* The settlement options described in this revenue procedure are available to any taxpayer that deducted for a taxable year the unpaid portion of accrued employee benefits based on the securitization of the benefits by a letter of credit, bond, or other similar financial instrument during the first 2½ months of the following taxable year. The employee benefits in question are primarily vacation pay, but may also include other benefits such as severance pay, disability pay, or sick pay.

.02 *Inapplicability.* This revenue procedure does not apply to a taxpayer unless the taxpayer, in accordance with the procedures set forth in Notice 99–16, 1999–13 I.R.B. 10, changes its method of accounting for its first taxable year ending after July 22, 1998, to comply with § 404(a)(11).

SECTION 5. OPTION ONE: ALTERNATIVE-TIMING SETTLEMENT

.01 *In General.* The Service offers to settle the issue with taxpayers subject to this revenue procedure by allowing taxpayers to deduct 50 percent of the accelerated deduction for a taxable year in the taxable year the benefits accrue and 50 percent in the taxable year the benefits are actually received by the employee (if vacation pay) or in the taxable year in which or with which ends the employee's taxable year in which the benefits were actually received (if benefits other than vacation pay). For taxpayers choosing this settlement option, the § 481(a) adjustment resulting from the change in method of accounting to comply with § 404(a)(11) would be reduced accordingly.

.02 *Terms of alternative-timing settlement.*

(1) The settlement will cover the taxpayer's earliest open taxable year after which there is no closed taxable year and all subsequent taxable years ending on or before July 22, 1998.

(2) The Service will allow 50 percent of the excess accelerated deduction for each of the taxable years covered by the settlement.

(3) The taxpayer's method of accounting for the unpaid portion of accrued employee benefits that the taxpayer secured during the first 2½ months of the following taxable year by purchasing a letter of credit or other similar financial instrument is not changed for the taxable years covered by the settlement;.

(4) The taxpayer must change its method of accounting for its first taxable year ending after July 22, 1998, to comply with § 404(a)(11).

(a) The § 481(a) adjustment resulting from the change will equal the aggregate of the excess accelerated deductions for all taxable years ending on or before July 22, 1998 (determined without regard to the special rule in section 3.02 of this revenue procedure for computing the excess accelerated deduction for the first taxable year covered by the settlement), and will be reduced by 50 percent of the aggregate of the excess accelerated deductions for the taxable years covered by the settlement.

(b) The § 481(a) adjustment will be taken into account ratably over a 3-taxable-year period beginning with the first taxable year ending after July 22, 1998.

(5) The Service will not require the taxpayer to change its method of accounting for the unpaid portion of accrued employee benefits that the taxpayer secured during the first 2½ months of the following taxable year by purchasing a letter of credit or other similar financial instrument, for taxable years ending on or before July 22, 1998.

SECTION 6. OPTION TWO: TIME-VALUE-OF-MONEY SETTLEMENT

.01 *In General.* The Service offers to settle the issue with taxpayers subject to this revenue procedure in exchange for taxpayers paying the government 50 percent of the time-value-of-money benefit the taxpayer derived from deducting the accelerated deduction for a taxable year in the taxable year the benefits accrue instead of in the taxable year the benefits are actually received by the employee (if vacation pay) or in the taxable year in which or with which ends the employee's taxable year in which the benefits were actually received (if benefits other than vacation pay).

.02 *Terms of time-value-of-money settlement.*

(1) The settlement will cover the taxpayer's earliest open taxable year after which there is no closed taxable year and all subsequent taxable years ending on or before July 22, 1998.

(2) The taxpayer will pay the government a "specified amount" that approximates the time-value-of-money benefit the taxpayer has derived from deducting the accelerated deductions for each of the taxable years covered by the settlement in the taxable year the benefits accrue instead of in the taxable year the benefits are actually received by the employee (if vacation pay) or in the taxable year in which or with which ends the employee's taxable year in which the benefits were actually received (if benefits other than vacation pay), reduced by 50 percent. The specified amount is not interest under § 163(a), and may not be deducted or capitalized under any provision of the Code.

(3) The specified amount equals the sum of the time-value-of-money benefit (detriment) computed with respect to each taxable year covered by the settlement, reduced by 50 percent. However, if the sum of the time-value-of-money benefit (detriment) computed with respect to each taxable year is negative, the specified amount will be zero and no refund will be made to the taxpayer. The time-value-of-money benefit (detriment) with respect to each taxable year covered by the settlement equals the "hypothetical underpayment (overpayment), " multiplied by the "applicable time-value rate," compounded daily for the "applicable period."

(a) *Hypothetical underpayment (overpayment).* The hypothetical underpayment (overpayment) for each taxable year covered by the settlement is equal to the excess accelerated deductions for the taxable year, multiplied by the applicable tax rate for the taxable year of the underpayment (overpayment). The applicable tax rate is the highest rate of income tax applicable to the taxpayer (for example, the highest rate in effect under § 1 for individuals or § 11 for corporations).

(b) *Applicable time-value rate.* The applicable time-value rate generally equals the average of the quarterly underpayment (overpayment) rates in effect under § 6621(a) for the applicable period. However, for a taxpayer that would be entitled to a deduction under § 163(a) for the specified amount if the specified amount were treated as interest arising from the underpayment of tax, the applicable time-value rate is computed at a reduced rate equaling the average of the quarterly underpayment (overpayment) rates in effect under § 6621(a) for the applicable period, multiplied by the excess of 100% over the applicable tax rate for the taxable year of the underpayment (overpayment).

(c) *Applicable period.* The applicable period begins on the due date (without regard to extensions) of the return for the taxable year of the underpayment (overpayment) and ends on the due date of the taxpayer's return (without regard to extensions) for its first taxable year ending after July 22, 1998.

(d) *Time-value-of-money formula.* The time-value-of-money benefit for each taxable year covered by the settlement is computed using the following formula:

$$U * \{[1 + (R/365)]N - 1\}$$

where U = hypothetical underpayment for the taxable year

R = the applicable time-value rate
N = the number of days in the applicable period

(4) The specified amount is not refundable or creditable against any federal tax liability of the taxpayer.

(5) The taxpayer's method of accounting for the unpaid portion of accrued employee benefits that the taxpayer secured during the first 2½ months of the following taxable year by purchasing a letter of credit or other similar financial instrument is not changed for the taxable years covered by the settlement.

(6) The taxpayer must change its method of accounting for its first taxable year ending after July 22, 1998, to comply with § 404(a)(11).

(a) The § 481(a) adjustment resulting from the change will equal the aggregate of the excess accelerated deductions for all taxable years ending on or before July 22, 1998 (determined without regard to the special rule in section 3.02 for computing the excess accelerated deduction for the first taxable year covered by the settlement).

(b) The § 481(a) adjustment will be taken into account ratably over a 3-taxable-year period beginning with the first taxable year ending after July 22, 1998.

(7) The Service will not require the taxpayer to change its method of accounting for the unpaid portion of accrued employee benefits that the taxpayer secured during the first 2½ months of the following taxable year by purchasing a letter of credit or other similar financial instrument, for taxable years ending on or before July 22, 1998.

SECTION 7. PROCEDURES FOR REQUESTING, PROCESSING, AND IMPLEMENTING A SETTLEMENT

.01 *Procedures for requesting the settlement.*

(1) *Initiating the request.*

(a) *In general.* A taxpayer that wants to request a settlement under this revenue procedure must submit its request for the settlement in writing to Sharon Russell (Vacation Pay Issue Specialist) on or before the later of October 1, 1999, or the due date of its return (determined with regard to extensions of time) for its first taxable year ending after July 22, 1998. The request must be addressed to the Internal Revenue Service, 5990 West Creek Road, Independence, Ohio 44131, Attention: Sharon Russell (Vacation Pay Issue Specialist), Exam Branch 2.

(b) *Taxpayer under examination.* A taxpayer that is under examination on June 14, 1999, that wants to request a settlement under this revenue procedure must submit its request to the case manager or group manager having jurisdiction of the case on or before October 1, 1999.

(c) *Service-initiated request.* A case manager or group manager may make a settlement offer under this revenue procedure in a case under their jurisdiction at any time during the examination.

(2) Statement of facts, law, and arguments. The request for settlement must include the following information:

(a) the taxpayer's name, address, telephone number, and taxpayer identification number;

(b) the type of settlement proposed by the taxpayer (alternative-timing or time-value-of-money);

(c) the taxable years covered by the proposed settlement;

(d) a statement of the material facts, including the amount of the accelerated deductions and excess accelerated deductions for each taxable year covered by the proposed settlement;

(e) an analysis of whether the amounts shown as accelerated deductions for each taxable year covered by the proposed settlement were incurred under § 461 in that taxable year;

(f) if the taxpayer is proposing an alternative-timing settlement under this revenue procedure, a statement that the taxpayer agrees to file amended returns to reflect the settlement for any affected taxable years covered by the settlement (not under examination);

(g) if the taxpayer is proposing a time-value-of-money settlement under this revenue procedure, a computation of the specified amount, including the supporting computations of the time-value-of-money benefit (detriment) with respect to each taxable year covered by the settlement;

(h) a statement that the taxpayer agrees that the Service is not changing the taxpayer's method of accounting for the taxable years covered by the settlement;

(i) a statement that the taxpayer has changed or agrees to change its method of accounting for its first taxable year ending after July 22, 1998, to comply with § 404(a)(11);

(j) the amount of the § 481(a) adjustment required as a result of the change to comply with § 404(a)(11) and, if the taxpayer is proposing an alternative-timing settlement, the reduction of the § 481(a) adjustment required as a result of the settlement;

(k) a statement that the Service is not precluded from challenging the amount of the accelerated deduction for any taxable year covered by the settlement on a basis unrelated to the securitization arrangement (e.g., that all or a portion of the amount is not incurred during that year under § 461); and

(l) a statement that the taxpayer accepts the settlement and agrees to the terms of this revenue procedure.

(3) *Perjury statement.* The request for settlement must be accompanied by the following declaration: **"Under penalties of perjury, I declare that I have examined this information, including accompanying documents, and, to the best of my knowledge and belief, the information contains all the relevant facts relating to the request for the information, and such facts are true, correct, and complete."** This declaration must be signed by, or on behalf of, the taxpayer by an individual with the authority to bind the taxpayer in such matters. The declaration may not be signed by the taxpayer's representative.

.02 *Procedures for processing the request.*

(1) *Receipt of request acknowledged.* The Vacation Pay Issue Specialist, case manager, or group manager (whichever is applicable) will acknowledge receipt of the taxpayer's request for settlement in writing within 15 days of receipt.

(2) *Factual development.* The Vacation Pay Issue Specialist, case manager, or group manager (whichever is applicable) will contact the taxpayer to discuss any questions that the Service may have, or ask for additional information believed to be necessary in order to execute the settlement.

(3) *Notification of acceptance.* The Vacation Pay Issue Specialist, case manager, or group manager (whichever is applicable) will notify the taxpayer in writing when the Service agrees to the settlement requested by the taxpayer. The notification of acceptance will set forth the material terms and conditions of the settlement.

(4) *Withdrawal of request for settlement.* The taxpayer may withdraw its request for the settlement any time prior to execution of the closing agreement required in section 7.03(1) of this revenue procedure or payment of the specified amount as required in section 7.03(2) of this revenue procedure. The withdrawal must be communicated in writing to the Vacation Pay Issue Specialist, case manager, or group manager (whichever is appropriate).

.03 *Procedures for implementing the settlement.*

(1) *Alternative-timing settlement.*

(a) *Closing agreement required.* A taxpayer implementing an alternative-timing settlement under this revenue procedure is required to execute a closing agreement under § 7121. The taxpayer must pay the government any taxes and interest due as a result of the settlement.

(b) *Contents of closing agreement.* A closing agreement finalizing an alternative-timing settlement under this revenue procedure must comply with the requirements of Rev. Proc. 68–16, 1968–1 C.B. 770, and must state:

(i) the name, address, telephone number, and taxpayer identification number of any taxpayer included in the agreement;

(ii) that the issue covered by the settlement is the timing of deductions for accrued vacation pay and other benefits unpaid during a taxable year for which the taxpayer purchased a letter of credit, bond, or other similar financial instrument to secure the benefits during the first 2½ months of the following taxable year;

(iii) the facts and representations upon which the taxpayer and the Service relied in reaching the agreement;

(iv) the definitions of accelerated deduction and excess accelerated deduction set forth in section 3 of this revenue procedure;

(v) the taxable years covered by the settlement;

(vi) that the Service is disallowing 50 percent of the excess accelerated deduction for each of the taxable years covered by the settlement;

(vii) that the Service is not changing the taxpayer's method of accounting for the taxable years covered by the settlement;

(viii) that the taxpayer is required to change its method of accounting for its first taxable year ending after July 22, 1998, to comply with § 404(a)(11);

(ix) the amount of the § 481(a) adjustment required as a result of the change to comply with § 404(a)(11);

(x) that the § 481(a) adjustment resulting from the change to comply with § 404(a)(11) will be reduced by 50 percent of the aggregate of the excess accelerated deductions for the taxable years covered by the settlement;

(xi) that the taxpayer has filed or will file amended returns to reflect the settlement for any affected taxable years covered by the settlement;

(xii) that the Service is not precluded from challenging the amount of the accelerated deduction for any taxable year covered by the settlement on a basis unrelated to the securitization arrangement (e.g., that all or a portion of the amount is not incurred during that year under § 461); and

(xiii) that the taxpayer accepts the alternative-timing settlement and agrees to the terms of this revenue procedure.

(c) *Review and execution of closing agreement.* The Vacation Pay Issue Specialist, case manager, or group manager (whichever is applicable) will prepare the closing agreement and submit the closing agreement to the taxpayer for execution. The closing agreement will be executed by the Service after it has been executed by the taxpayer and will be executed on behalf of the Service by the Vacation Pay Issue Specialist or, in the case of a taxpayer under examination, by the case manager or group manager having jurisdiction of the case. A case manager or group manager must submit a closing agreement to the Vacation Pay Issue Specialist for review prior to submitting the closing agreement to the taxpayer for execution.

(d) *Amended returns.*

(i) *In general.* A taxpayer implementing an alternative-timing settlement under this revenue procedure is required to file amended returns to reflect the settlement for any affected taxable years covered by the settlement. The amended returns must include the adjustments to taxable income and any collateral adjustments to taxable income or tax liability resulting from the settlement necessary to reflect the settlement.

(ii) *Years under examination.* If the taxpayer is under examination at the time the closing agreement is executed, the Service will make the adjustments necessary to reflect the settlement to the taxpayer's returns for the taxable years under examination and the taxpayer is required to file amended returns to reflect the settlement for any other affected taxable years covered by the settlement.

(iii) Time and manner. The Service may require the taxpayer to file the amended returns prior to executing the closing agreement, and in no event will the amended returns be filed later than 60 days after the date the Service executes the closing agreement. The taxpayer must provide a copy of the amended returns to the Vacation Pay Issue Specialist, case manager, or group manager (whichever is applicable) at the time it files the amended returns.

(e) *Compliance with § 404(a)(11).* A taxpayer implementing an alternative-timing settlement under this revenue procedure must change its method of accounting and file its returns for taxable years ending after July 22, 1998, in compliance with § 404(a)(11).

(2) *Time-value-of-money settlement.*

(a) *Payment of specified amount.* A taxpayer implementing a time-value of money settlement under this revenue procedure must pay the specified amount within 30 days of the date of the writing from the Service notifying the taxpayer of acceptance of the settlement. The payment must be sent to the Internal Revenue Service, Cincinnati Service Center, 201 W. River Center Blvd., Stop 31, Unit 21, Covington , KY 41019.

(b) *Statement.* The payment of the specified amount must be accompanied by the following information:

(i) the name, address, telephone number, and taxpayer identification number of the taxpayer;

(ii) a copy of the notification of acceptance from the Vacation Pay Issue Specialist described in section 7.02(3) of this revenue procedure; and

(iii) a statement that the taxpayer accepts the time-value-of-money settlement and agrees to the terms of this revenue procedure.

(c) *Perjury statement.* The information must be accompanied by the following declaration: "Under penalties of perjury, I declare that I have examined this information, including accompanying documents, and, to the best of my knowledge and belief, the information contains all the relevant facts relating to the request for the information, and such facts are true, correct, and complete." This declaration must be signed by, or on behalf of, the taxpayer by an individual with the authority to bind the taxpayer in such matters. The declaration may not be signed by the taxpayer's representative.

(d) *Label.* The following language must be either typed or legibly printed at the top of the first page of the information: PAYMENT OF SPECIFIED AMOUNT UNDER REV. PROC. 99–26".

(e) *Compliance with § 404(a)(11).* A taxpayer implementing a time-value-of-money settlement under this revenue procedure must change its method of accounting and file its returns for taxable years ending after July 22, 1998, in compliance with § 404(a)(11).

.04 *Authority to make and accept settlement offers.*

Examination case managers and group managers will have delegated authority to accept or make the settlement offers described in this revenue procedure and to execute required closing agreements for cases under their jurisdiction. The Vacation Pay Issue Specialist will have the same delegated authority to accept settlement offers and to execute closing agreements.

SECTION 8. EXAMPLE

.01 *Facts.* A taxpayer that is a corporation files its tax return on a calendar year basis. The taxpayer has a vacation plan that is based on the calendar year. Under the terms of the vacation plan, vacation earned in one year vests at the end of the year and cannot be used during the year earned. Vested vacation time must be used in the year following the year in which earned, or it is forfeited. Beginning in 1992, the taxpayer purchases a letter of credit on March 15 of every taxable year to secure the portion of vacation pay accrued in the prior taxable year that is unpaid on that date. All of the accrued vacation pay secured by the letter of credit is paid during the taxable year following the taxable year it accrued because none of the vacation pay is forfeited. The taxpayer deducts for the taxable year the unpaid portion of the accrued vacation pay based on the securitization of the benefits during the first 2½ months of the following taxable year. The amount of accrued and unpaid vacation benefits as of the end of the taxable year secured in the first 2½ months of the following taxable year (the accelerated deduction) is

$10,000,000 for 1991, $12,000,000 for 1992, $15,000,000 for 1993, $13,000,000 for 1994, $16,000,000 for 1995, $16,000,000 for 1996, and $18,000,000 for 1997.

.02 *Alternative-timing settlement.* The taxpayer is examined for the 1992 and 1993 taxable years (1992 is the earliest open taxable year after which there is no closed taxable year). The taxpayer and the Service agree to settle the issue on the basis of the alternative-timing settlement in section 5 of this revenue procedure.

(1) The accelerated deduction for each taxable year is the amount of accrued and unpaid vacation benefits as of the end of the taxable year secured in the first 2½ months of the following taxable year (Exhibit I, Column A).

(2) The amount of the accelerated deductions for prior taxable years that was actually received by employees during each taxable year is the accelerated deduction for the prior taxable year because the portion of the unpaid vacation pay secured by the letter of credit is paid in the taxable year following the taxable year it accrues (Exhibit I, Column B).

(3) The excess accelerated deduction for each taxable year covered by the settlement is the accelerated deduction for the taxable year less the accelerated deduction for the prior taxable year, except that the excess accelerated deduction for 1992 (the first taxable year covered by the settlement) is the accelerated deduction for the taxable year (Exhibit I, Column C).

(4) The Service will disallow 50 percent of the excess accelerated deduction for 1992 and 1993. (Exhibit I, Column D).

(5) The taxpayer is required to amend its returns for 1994, 1995, and 1997 to reflect the disallowance of 50 percent of the excess accelerated deduction for each of those taxable years. (Exhibit I, Column D)

(6) The taxpayer is required to change its method of accounting for 1998 (its first taxable year ending after July 22, 1998) to comply with § 404(a)(11).

(a) The § 481(a) adjustment resulting from the change will equal $9,000,000, determined as follows: the aggregate of the excess accelerated deductions for all taxable years ending on or before July 22, 1998 (determined without regard to the special rule in section 3.02 for computing the excess accelerated deduction for the first taxable year covered by the settlement) [$18,000,000], reduced by 50 percent of the aggregate of the excess accelerated deductions for the taxable years covered by the settlement [$9,000,000] (Exhibit II).

(b) The § 481(a) adjustment will be taken into account ratably over a 3-taxable-year period beginning with the first taxable year ending after July 22, 1998.

.03 *Time-value-of-money settlement.* The taxpayer accepts the offer to settle the issue on the basis of the time-value-of-money settlement in section 6 of this revenue procedure. The specified amount would be deductible under § 163(a) by the taxpayer if it were treated as interest expense arising from an underpayment of tax.

(1) The taxpayer must pay the specified amount of $994,379, computed as follows:

(a) The hypothetical underpayment of tax for 1992 is $4,080,000, computed as follows: the excess accelerated deduction of $12,000,000 multiplied by the applicable tax rate of 34%. The applicable time-value rate for 1992 is 5.46%, which is computed as follows. The applicable period for 1992 is March 15, 1993 (the due date of the return without extensions) to March 15, 1999. The underpayment rates in effect for the applicable period are 7%, 7%, 7%, 7%, 7%, 7%, 8%, 9% , 9%,10%, 9%, 9%, 9%, 8%, 9%, 9%, 9%, 9%, 9%, 9%, 9%, 8%, 8%, 8%, 7%. The average underpayment rate in effect for the applicable period is 8.28% [(7+7+7+7+7+7+8+9+9+10+ 9+ 9+9+8+9+9+9+9+9+9+9+8+8+8+7)/25]. The applicable after-tax time-value rate is 5.46%, computed by multiplying the average underpayment rate by one minus the applicable tax rate [8.28% * (1–.34)]. The time-value-of-money benefit for 1992 is $1,582,254, computed as follows: $\$4,080,000 * \{[1 + (.0546/365)]^{2191} – 1\}$.

(b) The hypothetical underpayment of tax for 1993 is $1,050,000, computed as follows: the excess accelerated deduction of $3,000,000 multiplied by the applicable tax rate of 35%. The applicable time-value rate for 1993 is 5.54%, which is computed as follows. The applicable period for 1993 is March 15, 1994 (the due date of the return without extensions) to March 15, 1999. The underpayment rates in effect for the applicable period are 7%, 7%, 8%, 9% , 9%,10%, 9%, 9%, 9%, 8%, 9%, 9%, 9%, 9%, 9%, 9%, 9%, 8%, 8%, 8%, 7%. The average underpayment rate in effect for the applicable period is 8.52% [(7+7+ 8+9+9+10+ 9+ 9+9+8+9+9+9+9+9+9+ 9+8+8+8+7)/21]. The applicable after-tax time-value rate is 5.54%, computed by multiplying the average underpayment rate by one minus the applicable tax rate [8.52% * (1–.35)]. The time-value-of-money benefit for 1993 is $335,306, computed as follows: $\$1,050,000 * \{[1 + (.0554/365)]^{1826} – 1\}$.

(c) The hypothetical overpayment of tax for 1994 is $700,000, computed as follows: the excess accelerated deduction of ($2,000,000) multiplied by the applicable tax rate of 35%. The applicable time-value rate for 1994 is 5.01%, which is computed as follows. The applicable period for 1994 is March 15, 1995 (the due date of the return without extensions) to March 15, 1999. The overpayment rates in effect for the applicable period are 8%,9%, 8%, 8%, 8%, 7%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 7%, 7%, 7%, 6%. The average overpayment rate in effect for the applicable period is 7.71% [(8+9+8+ 8+8+7+8+8+8+8+8+8+8+7+7+7+6)/17]. The applicable after-tax time-value rate is 5.01%, computed by multiplying the average overpayment rate by one minus the applicable tax rate [7.71% * (1–.35)]. The time-value-of-money detriment for 1994 is $155,430, computed as follows: $\$700,000 * \{[1 + (.0501/365)]^{1461} – 1\}$.

(d) The hypothetical underpayment of tax for 1995 is $1,050,000, computed as follows: the excess accelerated deduction of $3,000,000 multiplied by the applicable tax rate of 35%. The applicable time-value rate for 1995 is 5.55%, which is computed as follows. The applicable period for 1995 is March 15, 1996 (the due date of the return without extensions) to March 15, 1999. The underpayment rates in effect for the applicable period are 9%, 8%, 9%, 9%, 9%, 9%, 9%, 9%, 9%, 8%, 8%, 8%, 7%. The average underpayment rate in effect for the applicable period is 8.54% [(9+8+9+ 9+9+9+9+9+9+8+8+ 8+7)/13]. The applicable after-tax time-value rate is 5.55%, computed by multiplying the average underpayment rate by one minus the applicable tax rate [8.54% * (1–.35)]. The time-value-of-money benefit for 1995 is $190,206, computed as follows: $\$1,050,000 * \{[1 + (.0555/365)]^{1095} – 1\}$.

(e) There is no time-value-of-money benefit or detriment in 1996.

(f) The hypothetical underpayment of tax for 1997 is $700,000, computed as follows: the excess accelerated deduction of $2,000,000 multiplied by the applicable tax rate of 35%. The applicable time-value rate for 1997 is 5.2%, which is computed as follows. The applicable period for 1997 is March 15, 1998 (the due date of the return without extensions) to March 15, 1999. The underpayment rates in effect for the applicable period are 9%, 8%, 8%, 8%, 7%. The average underpayment rate in effect for the applicable period is 8% [(9+8+8+8+7)/5]. The applicable after-tax time-value rate is 5.2%, computed by multiplying the average underpayment rate by one minus the applicable tax rate [8% * (1-.35)]. The time-value-of-money benefit for 1997 is $37,360, computed as follows: $\$700,000 * \{[1 + (.052/365)]^{365} – 1\}$.

(g) The sum of the time-value-of-money benefit (detriment) computed with respect to each taxable year covered by the settlement is $1,989,696, computed as follows: $1,582,254+$335,306–$155,430+$190,206+$37,360.

(h) The specified amount is $994,848, computed as follows: $1,989,696 times 50 percent.

(2) The taxpayer is required to change its method of accounting for 1998 (its first taxable year ending after July 22, 1998) to comply with § 404(a)(11).

(a) The § 481(a) adjustment resulting from the change will equal $18,000,000, the aggregate of the excess accelerated deductions for all taxable years ending on or before July 22, 1998 (determined without regard to the special rule in section 3.02 for computing the excess accelerated deduction for the first taxable year covered by the settlement) (Exhibit II).

(b) The § 481(a) adjustment will be taken into account ratably over a 3-taxable-year period beginning with the first taxable year ending after July 22, 1998.

SECTION 9. EFFECT ON OTHER OFFICES OF THE SERVICE

The provisions of this revenue procedure are not intended to preclude an appropriate representative of the Service from settling a particular taxpayer's case involving this issue on a more favorable or less favorable basis than provided in this revenue procedure. For example, an appeals officer may settle a case based on the hazards of litigation.

SECTION 10. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1653.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this revenue procedure is in section 7 of this revenue procedure. The information is required to ensure that the settlement amount required to be paid under this revenue procedure is accurately computed and timely paid. The likely respondents are businesses that pay deferred benefits.

The estimated total annual reporting burden is 2,000 hours.

The estimated annual burden per respondent will vary from 10 hours to 30 hours, depending on individual circumstances, with an estimated average of 20 hours. The estimated number of respondents is 100.

The estimated annual frequency of responses is one time.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this revenue procedure is Robert Testoff of the Office of the Assistant Chief Counsel (Income Tax & Accounting). For further information regarding this settlement initiative contact Sharon Russell (Vacation Pay Issue Specialist) at (216) 328-2824 (not a toll-free call).