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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR LARGE and MID-SIZE BUSINESS, Associate Area Counsel -- Denver CC:LM:NR:DEN

FROM: ASSOCIATE CHIEF COUNSEL (Income Tax and Accounting) CC:ITA

SUBJECT: Application of I.R.C. § 263A to Benefit Costs Paid on Behalf of Former Employees

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LEGEND

Corporation =

ISSUE

Whether certain employee benefits paid by Corporation for production employees who performed services in a previous year are subject to capitalization as an indirect production cost.

CONCLUSION

Amounts paid by Corporation for certain employee benefits for production employees who performed services in a previous year are subject to capitalization as an indirect production cost.

FACTS

Corporation, in the utility industry, is a member of a consolidated group for the tax years under examination. During the years under examination, Corporation incurred significant annual construction expenditures. Accordingly, Corporation was a significant producer of property and was subject to the uniform capitalization rules. The years under examination are prior to the final uniform capitalization rules, which were final for years beginning after December 31, 1993.

During the years under examination, Corporation, among its many costs, incurred costs associated with the services of former employees. Corporation provided health care and life insurance benefits to its retired employees. These costs for past service are costs incurred in the current year (in the form of employee benefits) relating to employees who performed services in a previous year. Corporation incurred certain employee benefits costs for both current and past employees. Corporation also incurred other employee benefit costs for current employees. Corporation did not capitalize the past service costs for the retired employees as an indirect cost of production activities under section 263A.[1]

LAW AND ANALYSIS

Section 263A provides uniform rules for capitalization or inclusion in inventory of certain expenses. Section 263A(b) provides, in part, that section 263A applies to real or tangible personal property produced by the taxpayer. Section 263A(g)(1) provides that the term “produce” includes construct, build, install, manufacture, develop, or improve.

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[1]The issue only involves retired employees who were former production employees.

Where section 263A applies, a taxpayer must include in inventory costs or capitalize the direct costs and the proper share of those indirect costs (including taxes) part or all of which are allocable to such property subject to section 263A.

Temp. Treas. Reg. § 1.263A-1T(b)(2)(ii) provides that a taxpayer must capitalize all indirect costs properly allocable to property produced. Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities.

Temp. Treas. Reg. § 1.263A-1T(b)(2)(iii)(P) provides that among the indirect costs required to be capitalized are contributions paid to or under a stock bonus, pension, profit-sharing or annuity plan, or other plan deferring the receipt of compensation whether or not the plan qualifies under section 401(a) (except for amounts described in paragraph (b)(2)(v)(H) of this section), and other employee benefit expenses paid or accrued on behalf of labor, to the extent such contributions or expenses are otherwise allowable as deductions under chapter 1 of the Code. "Other employee benefit expenses" include (but are not limited to) payments pursuant to a wage contribution plan under section 105(d) as it existed prior to its repeal in 1983 and premiums on life and health insurance.

Patterned after the long-term contract rules for pensions in Treas. Reg. § 1.451-3, Temp. Treas. Reg. § 1.263A-1T(b)(2)(v)(H)(1) provides that among the indirect costs not required to be capitalized are contributions paid to or under a pension or annuity plan allowable as a deduction under section 404 (and section 404A if applicable) to the extent such contributions represent past service costs as determined under the particular funding method established for the plan for the period in question under the provisions of section 412.

In the Preamble to the Temporary Regulations, under the heading Pension Costs–Past Service Costs, the Treasury explained the initial provision regarding past service costs for pensions in this way:

> Under the temporary regulations, contributions paid to or under a pension or annuity plan which are allowable under section 404 (and section 404A if applicable), are not subject to the capitalization requirements of section 263A to the extent that such contributions represent "past service costs." Until otherwise provided to the contrary, past service costs shall be determined, for purposes of section 263A, with reference to the allocation between "normal costs" and "past service costs" under the funding standards of section 412. With respect to an actuarial method which does not distinguish between normal costs and

> past service costs, none of the amount allowable as a deduction under section 404 shall be treated as past service costs.

T.D. 8131 (Preamble), printed in 1987-1 C.B. 98, 104.

The Joint Committee on Taxation, in its explanation of the pension costs and past service costs ("Blue Book"), stated:

> Pension costs
>
> Under the uniform capitalization rules, contributions to a pension, profit-sharing, or stock bonus plan and other employee benefit expenses are considered indirect costs that must be capitalized to the same extent as other indirect costs, unless such contributions relate to past-service costs. It was intended that, in the case of a contribution to a qualified plan, the determination of whether the contribution relates to past or current services will be made independently of any allocation between "normal cost" and "past-service cost" required under the minimum funding standards (sec. 412) or under the plan's benefit formula. The Congress anticipated that the Treasury Department will publish guidelines for making this determination, and that such determination may be based, in whole or in part, on any actuarial funding methods that may be utilized by qualified defined benefit plans.

Joint Committee on Taxation Staff, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st Sess. (1987) at 512.

Past service costs refers to those costs for retirement benefits that are based upon the employee's years of service with the employer prior to the inception of a defined benefit plan. See generally Section 412.

Section 10204 of the Omnibus Budget Reconciliation Act of 1987, P.L. No. 100-203, Dec. 22, 1987 ("1987 Act"), overruled the exception which permitted the deduction for past service costs for contributions to certain pension or annuity plans. Omnibus Budget Reconciliation Act of 1987, § 10204, P.L. No. 100-203, Dec. 22, 1987, reprinted in 1987-3 C.B. 114. Section 10024(a) of the 1987 Act provided that for purposes of section 263A, the allocable costs with respect to any property shall include contributions paid to or under a pension or annuity plan whether or not such contributions represent past service costs. The change in law was effective for years beginning after December 31, 1987.

The legislative history to section 10204 of the 1987 Act is found under the heading "Treatment of past service pension costs under uniform capitalization rules":

> *House bill*
>
> No provision.
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> *Senate amendment*
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> Under the Senate amendment, past service costs are subject to the uniform capitalization rules. Thus, an allocable portion of all otherwise allowable pension costs, whether relating to current or past services, must be included in the basis of the property produced by the taxpayer or held for resale by the taxpayer.
>
> *Conference agreement*
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> The conference agreement generally follows the Senate amendment with respect to the costs allocable to property produced by the taxpayer or held for resale by the taxpayer.

H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 925 (1987), 1987-3 C.B. 204.

Under the final regulations, Congress' mandate for the change in law regarding the past service costs for pension plans is incorporated. For pension and other related costs, contributions to employee plans representing past services must be capitalized in the same manner as amounts contributed for current service. Treas. Reg. § 1.263A-1(e)(3)(ii)(C). Other employee benefit expenses, including premiums on life and health insurance, and wage continuation plan payments under former section 105(d), must also be capitalized. Treas. Reg. § 1.263A-1(e)(3)(ii)(D).

The costs under consideration here involve certain employee benefit costs for production employees who performed service in a previous year. These costs do not involve pension or annuity costs. Rather, the costs involve life insurance and health care premiums, i.e., they are other benefit costs. The issue is whether the "past service costs" language associated with the pension costs in the temporary regulations has any impact on payments for benefits for prior service involving other types of benefit costs. The original temporary and proposed regulations indicated in the Preamble that past service costs for pensions were not subject to capitalization. Congress in 1987 specifically changed the Service's position on past service costs for pensions, mandating that such past service costs must be capitalized.

Taxpayer argues that all past service costs are deductible under the temporary regulations, with the pension costs specifically singled out. This would apply whether it is a past service costs for a current employee or a cost incurred for a retired employee for prior service. Congress remedied the treatment of pension costs, by the law change in 1987, but did not address other past service costs. Taxpayer points to the silence of the regulations regarding these costs and also the Blue Book's interpretation of past service costs.

Our view is that the original temporary regulations required all past service costs for employee benefits to be capitalized, except pension costs. The exclusion for pension costs followed from the long-term contract regulations, upon which the uniform capitalization rules were modeled. When the past service pension costs exception was specifically overruled by Congress in 1987, then all past service costs were treated alike: all were capitalizable.

Retiree benefits are incurred by reason of the performance of production activities, and are thus an indirect cost to be capitalized under Temp. Treas. Reg. § 1.263A-1T(b)(2)(ii). Temp. Treas. Reg. § 1.263A-1T(b)(2)(ii) provides that producers must capitalize direct and indirect costs properly allocable to property produced under section 263A, without regard to whether those costs are incurred before, during, or after the production period.

Even prior to section 263A, there was a requirement to capitalize all costs incurred in the construction of capital assets. See Treas. Reg. § 1.263(a)-2(a); Commissioner v. Idaho Power Co., 418 U.S. 1 (1974) (requiring depreciation used in the construction of a capital asset to be capitalized to the capital asset); Coors v. Commissioner, 60 T.C. 368 (1973), aff'd sub nom., Adolph Coors Co. v. Commissioner, 519 F.2d 1280 (10th Cir. 1975), cert. denied, 423 U.S. 1087 (1976) (requiring capitalization of certain construction department overhead costs as well as other construction-related costs); and Louisville & Nashville Railroad Co. v. Commissioner, 66 T.C. 962 (1976), aff'd in part, rev'd in part, 641 F.2d 435 (6th Cir. 1981) (requiring capitalization of health and welfare benefits applicable to direct and indirect labor involved in construction activity). Section 263A similarly requires capitalization of all costs incurred in the construction of capital assets.

Additionally, capitalization of recurring costs subject to the economic performance rules of section 461(h) is best accomplished by capitalization of past service costs to current production. This is the best alternative, since costs cannot be capitalized any earlier than when incurred under Treas. Reg. § 1.446-1(c)(1)(ii), and tracing is administratively impractical. Accordingly, capitalizing some retiree benefit costs each year clearly reflects income and is an administratively feasible methodology that ensures general matching and treatment consistent with that of salaries and other benefits.

Our view that when the past service pension costs exception was specifically overruled by Congress in 1987, then all the past service costs were treated alike -- all were capitalizable – is buttressed by legislative history. The legislative history to section 10204 of the 1987 Act, under "Senate amendment," states that "past service costs are subject to the uniform capitalization rules." H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 925 (1987), 1987-3 C.B. 204 (emphasis added).[2] The conference agreement followed the Senate amendment. The change under section 10204 of the 1987 Act to require capitalization of past service pension costs arguably reflects Congressional intent that the law requires capitalization of all past service pension and employee benefits costs. Hence, the language used in the legislative history: "past service costs are subject to the uniform capitalization rules." That is, now that past service costs for pensions were to be capitalized, all past service costs are treated alike -- all are subject to the uniform capitalization rules.

Furthermore, we note that the temporary and final regulations involving indirect production costs, in the definition of "other employee benefit expenses," both include a specific situation where there was a requirement to capitalize a cost in the current year for a former worker. Temp. Treas. Reg. § 1.263A-1T(b)(2)(iii)(P) and Treas. Reg. § 1.263A-1(e)(3)(ii)(D) provide that among the indirect costs required to be capitalized are payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983. Section 105(d) wage continuation plans involve payments to former employees who retired on total or permanent disability. Thus, like the employee benefits provided to the production employees who performed services in a previous year that are the subject of this advice, wage continuation plan payments involve current year costs for former workers. Accordingly, within the definition of "other employee benefit expenses" found in the temporary and final regulation, there is an analogous situation involving costs incurred in the current year for services in a previous year. We interpret the regulation as requiring capitalization of these costs.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This issue is not free from doubt. Past service costs do not benefit and are not incurred by reason of current production activity. Furthermore, there is no specific requirement in the temporary regulations or the final regulations, relating to employee benefit expenses, for capitalization of past service costs. No cases have been found that specifically address past service costs. Finally, one can argue that since the taxpayer is not obligated to provide benefits to retirees, retiree benefits should be treated as a current period cost.

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[2] The Conference Report is legislative history, as opposed to the Blue Book, written by the Joint Committee on Taxation. The Blue Book is "not part of the legislative history although it is entitled to respect." Redlark v. Commissioner, 106 T.C. 31, 45 (1996) (citations omitted).

On the other hand, we do not believe that the lack of a specific reference to capitalizing past service employee benefit costs in Temp. Treas. Reg. § 1.263A-1T(b)(2)(iii)(P) is determinative. Congress intended to include all types of direct and indirect costs as subject to capitalization, and past service costs are indirect costs of production. While it is a cost paid in the current year for people who no longer work, the cost is paid to those who were production employees. Accordingly, this year's production costs include benefits paid on behalf of both current and former production employees. And, since costs cannot be capitalized any earlier than when incurred under Treas. Reg. § 1.446-1(c)(1)(ii), it makes the most administrative sense to require capitalization of past service costs in the current year. Finally, it is reasonable to apply consistent treatment to all past service employee benefit costs, such as pensions, other employee benefits, vacation pay, wage continuation plans, etc.

Please call if you have any further questions.

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