An Examination of VEBA's and Deductions: Current or Deferred Compensation?

Deferred compensation is a term used in the Internal Revenue Code sections that govern an employer's deduction for contributions to an employee benefit plan and in the Treasury Regulations that define tax-exempt voluntary employees' beneficiary associations (VEBA's). This Comment discusses the interpretation and application of the deferred compensation rules and suggests that a better approach to defining deferred compensation be developed.

INTRODUCTION

In February of 1984, the staff of the Joint Committee on Taxation released a pamphlet analyzing and offering proposals about a variety of tax shelters and tax motivated transactions.[1] Close on the heels of these proposals, the House Ways and Means Committee reported out the Tax Reform Act of 1984,[2] and the Senate Finance Committee approved the Deficit Reduction Tax Act of 1984.[3] Two of the many areas addressed in both the Joint Committee pamphlet[4] and the proposed legislation[5] are the timing of an employer's deduction for contributions to an

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[1] STAFF OF JOINT COMM. ON TAX'N, 98TH CONG., 2D SESS., PROPOSALS RELATING TO TAX SHELTERS AND OTHER TAX-MOTIVATED TRANSACTIONS (Joint Comm. Proposals) [hereafter JOINT COMM. PROPOSALS].

[2] H.R. 4170, 98th Cong., 2d Sess. (1984) [hereafter Tax Reform Act of 1984]. The bill was reported out on March 5, 1984.

[3] H.R. 2163, 98th Cong., 2d Sess. (1984) (approved Mar. 21, 1984 as Senate amendments to House's proposed Federal Boat Safety Act of 1983) [hereafter Deficit Reduction Tax Act of 1984].

[4] The proposals released by the Joint Committee covered a broad range of issues relating to tax shelters, accounting abuses, and corporation reforms. *See* JOINT COMM. PROPOSALS, *supra* note 1.

[5] The Tax Reform Act of 1984 is an omnibus piece of legislation covering life insurance, private foundations, fringe benefits, tax-exempt bond issues, social security, Medicare, trade adjustment assistance, highway revenue, and various tax simplification provisions, as well as specific tax reforms in many of the areas discussed in the Joint Committee pamphlet. *See* Tax Reform Act of 1984, *supra* note 2. The Deficit Reduc-

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employee benefit plan[6] and the use of voluntary employees' beneficiary associations (VEBA's)[7] to fund such plans.[8] This Comment will explore these two areas in greater depth, and will particularly examine the role the term "deferred compensation" has played with respect to both the employer's deduction and VEBA's.

Under current tax law, employer contributions to an employee benefit plan that provides deferred compensation are deductible in the year paid or accrued.[9] If the plan provides deferred compensation, however, the employer can only currently deduct its contributions if the plan meets specific qualifications.[10] Deferral offers substantial tax savings to both employer and employee,[11] but the qualification requirements for

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tion Tax Act of 1984 addresses many of the same areas. *See* Deficit Reduction Tax Act of 1984, *supra* note 3.

[6] Deficit Reduction Tax Act of 1984, *supra* note 3, § 95, at 297-302; Tax Reform Act of 1984, *supra* note 2, §§ 111-112, at 200-12; JOINT COMM. PROPOSALS, *supra* note 1, at 78-89.

[7] *See* I.R.C. § 501(c)(9); *infra* notes 19-36 and accompanying text. All Code citations are to the Internal Revenue Code of 1954, as amended, unless otherwise stated.

[8] Deficit Reduction Tax Act of 1984, *supra* note 3, §§ 96-97, at 301-13; Tax Reform Act of 1984, *supra* note 2, § 113, at 212-16; JOINT COMM. PROPOSALS, *supra* note 1, at 84-86, 88.

[9] *See* I.R.C. § 162(a); Treas. Reg. § 1.162-10 (1960); *infra* notes 38-43 and accompanying text. All Treasury Regulation citations indicate the last amendment to the Regulation.

[10] *See* I.R.C. § 401 (qualification requirements for deferred compensation plans); I.R.C. § 404(a)(1)-(5) (limits deduction to plans providing deferred compensation). For further discussion of the deductibility of employer contributions to employee benefit plans, see *infra* notes 37-49 and accompanying text.

In addition to permitting an employer to deduct its contributions immediately, a qualified plan, *see infra* note 12, is exempt from taxation, *see* I.R.C. § 501(a), and the employee is not taxed on the contribution until it is distributed, *see* I.R.C. § 402(b); *see also infra* note 47.

[11] Because recognition of income from many fringe benefits is either statutorily excluded or is deferred until actual receipt, *see infra* note 47, the after-tax value to the employee of a fringe benefit dollar is greater than a dollar of wages. *See* Finneran, *Fringe Benefit or "Condition of Employment": Uniformity, Certainty, and Compliance,* 78 NW. U.L. REV. 198, 199 n.10 (1983); *cf.* Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality,* 70 VA. L. REV. 419, 429-33 (1984) (discussing tax subsidy to employees in qualified retirement plans). The employer, by providing fringe benefits, may either decrease its total compensation expense without affecting the employee's after-tax income, or can increase the level of compensation without affecting its payroll costs. Therefore, so long as employee fringe benefits are deductible by the employer to the same extent as are wages, the employer has an incentive to provide them. *But cf.* Wolk, *supra,* at 430 (suggesting employer indifference to creation of qualified retirement plan). If the employer can deduct its contributions in the taxable year paid or accrued, and the employee does not recognize

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deferred compensation plans are stringent.[12] Therefore, a plan's benefits may be characterized as welfare benefits to avoid the timing rules applicable to deferred compensation plans. Because many welfare plans actually defer the employee's receipt of benefits,[13] determining when a benefit involves deferred compensation is a vexing problem with which the Internal Revenue Service (IRS) and the courts have grappled.

VEBA's have received attention in recent years as a method of funding employee benefit plans.[14] Like a qualified deferred compensation

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income in that year, the net effect is an interest-free loan from the government. *See* JOINT COMM. PROPOSALS, *supra* note 1, at 5. If, in addition to the income deferral, the plan accumulates interest and earnings exempt from taxation, the net effect is even greater. *See* JOINT COMM. PROPOSALS, *supra* note 1, at 83 Table 3 (comparing accumulation available under four different types of compensation plans).

[12] Because Congress sought to encourage retirement plans for employees, *see* H.R. REP. NO. 2333, 77th Cong., 2d Sess. 103 (1942), several tax advantages are associated with certain deferred compensation plans. If a deferred compensation plan is qualified, *see* I.R.C. § 401, the plan is exempt from taxation, I.R.C. § 501(a), the employer can deduct its contributions, within limits, in the taxable year paid to the plan, *see* I.R.C. § 404(a)(1)-(4), and the employee does not recognize income until benefits are distributed from the plan, I.R.C. § 402(a). However, Congress was also concerned with the stability of the plan and protecting employees' retirement security. *See* H.R. REP. NO. 533, 93d Cong., 1st Sess. 1-3 (1973). Thus, § 401 and related Code sections set forth stringent requirements for a plan to qualify for the favorable tax treatment. *See, e.g.*, I.R.C. § 401(a)(2) (trust instrument must prohibit trust income and corpus from being used for or diverted to purposes other than exclusive benefit of employees); I.R.C. §§ 401(a)(3), 410 (minimum participation standards); I.R.C. § 401(a)(4), (5) (plan may not discriminate in favor of employees who are officers, shareholders, or highly compensated); I.R.C. §§ 401(a)(7), 411 (minimum vesting standards); I.R.C. § 401(a)(9) (required distributions); I.R.C. § 416 (requirements for top-heavy plans). A more detailed discussion of qualified plans is beyond the scope of this Comment. *See generally* M. CANAN, QUALIFIED RETIREMENT PLANS (1977); Stanger, *Tax-Qualified Retirement Plans After TEFRA: Limitations on Benefits and Contributions and Top-Heavy Plan Rules*, 41 INST. ON FED. TAX'N § 37.01 (1983).

[13] Unemployment, accident, and health benefits involve an element of deferral in that the services which earn an employee the right to receive such benefits are performed prior to the actual receipt of the benefits. Grant-Jacoby, Inc. v. Commissioner, 73 T.C. 700, 713 (1980) (discussing deferred compensation element in fringe benefits with respect to employer's deduction). However, such benefits have not been considered deferred compensation within the meaning of the Code, but instead are regarded as welfare. Kelly, *"Similar Benefit Plans" Under Internal Revenue Code Section 404(a) Versus Vacation, Dismissal, and SUB Plans*, 39 INST. ON FED. TAX'N § 6.01, § 6.01, at 6-3 (ERISA Supp. 1981).

[14] *See* Boyers & Klein, *An Analysis of the Federal Income Tax Consequences of Severance Pay Plans Funded Through Section 501(c)(9) Trusts*, 9 J. PENS. PLAN. & COMPLIANCE 45, 45 (1983); Greenblatt, *New Prop. Regs. Expand the Use of Voluntary Employees' Beneficiary Associations*, 53 J. TAX'N 210, 210 (1980) [hereafter Greenblatt, *New Prop. Regs.*]. The number of § 501(c)(9) organizations has increased

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plan, a VEBA is exempt from federal taxation,[15] but the qualification standards for VEBA's are less stringent than those applicable to deferred compensation plans.[16] The Treasury Regulations (regulations) set forth the requirements applicable to VEBA's, including the scope of permissible benefits.[17] Among these regulations is a prohibition on de-

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from 7791 on November 30, 1980, to 9400 in January, 1984. JOINT COMM. PROPOSALS, *supra* note 1, at 84 (indicates growth rate of 21% for 1983-84). The staff of the Joint Committee on Taxation suggests that one factor contributing to the increased interest in VEBA's could be the developing judicial interpretation of deferred compensation, which is the subject of this Comment. JOINT COMM. PROPOSALS, *supra* note 1, at 84-85.

Employers may opt for a VEBA to self-insure employee fringe benefits. *See* Curtiss, *Employer Contributions to Voluntary Employees' Beneficiary Associations*, 52 TAXES 5, 5 (1974). The employers, through self-insurance, hope to eliminate the profit and retention charges of a commercial insurer, retain funds for investment which would otherwise be required for reserves, and avoid state premium taxes. Dunkle, *Final Regulations Stimulate Use of Section 501(c)(9) Trusts*, 59 TAXES 226, 227 (1981) [hereafter Dunkle, *Final Regulations*]; *see also* Greenblatt, *Tax Advantages Available Through Section 501(c)(9) Trusts*, 41 INST. ON FED. TAX'N § 36-01, § 36-02, at 36-3 (1983) (employees can prefund expenses through VEBA as contributions generally deductible under I.R.C. § 162) [hereafter Greenblatt, *Tax Advantages*]; Stuchiner, *Using a 501(c)(9) Trust to Fund Employee Benefits*, 112 TR. & EST. 242, 242-43 (1973) (comparing VEBA's to insured benefit plans). *But see* Comm. on Pension & Profit-Sharing Trusts, A.B.A. Sec. of Real Prop., Prob. & Tr. Law, *Voluntary Employees' Beneficiary Associations to Provide Medical, Disability and Other Benefits: A Legal Analysis*, 8 REAL PROP. PROB. & TR. J. 666, 674-81 (1973) (state insurance law and state premium taxes should apply to VEBA's) [hereafter Comm. on Pension & Profit-Sharing Trusts, *Legal Analysis*]; Stuchiner, *supra*, at 242-43 (disadvantages of VEBA's as compared to insured arrangements). VEBA's are also marketed by commercial insurers, particularly for life benefits. *See* Powell & Schumaker, *Voluntary Employees' Beneficiary Associations (I.R.C. Section 501(c)(9) Trusts)*, CHARTERED LIFE UNDERWRITERS J., Jan. 1983, at 68.

[15] I.R.C. § 501(a) exempts from federal income taxation organizations described in § 501(c). *See infra* note 19.

[16] Although the VEBA regulations impose an antidiscrimination rule, *see* Treas. Reg. § 1.501(c)(9)-4 (1980), the rule is not as stringent as the antidiscrimination standard applicable to qualified deferred compensation plans. JOINT COMM. PROPOSALS, *supra* note 1, at 79; *see also* Preamble to T.D. 7750, 1981-1 C.B. 338, 339. VEBA's do impose limitations on participation. Treas. Reg. § 1.501(c)(9)-2(a)(2) (1980); Glickman, *Voluntary Employees' Beneficiary Associations: Four Key Issues*, 61 TAXES 743, 744-45 (1983). IRS letter rulings have required that VEBA funding be made on a level actuarial basis. LTR 8035095 (June 9, 1980); LTR 8035084 (June 6, 1980); LTR 8035066 (June 5, 1980); *see also* Greenblatt, *Tax Advantages*, *supra* note 14, § 36.04, at 36-6 to 36-7 (discussing VEBA funding). Rules regarding vesting, permanency, and the like applicable to qualified plans, *see supra* note 12, have no counterpart in the VEBA regulations.

[17] *See* Treas. Reg. § 1.501(c)(9)-1 to -8 (1980).

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ferred compensation.[18] Thus, the definition of deferred compensation is again the turning point in the analysis.

This Comment will examine the definition of deferred compensation as it applies to VEBA's and to the employer's deduction for contributions to employee benefit plans. It analyzes deferred compensation in the context of four different types of benefit plans: severance pay and supplemental unemployment benefit plans, vacation plans, educational benefit trusts, and retired lives reserves. Part I reviews the statutory and regulatory background for this analysis. Part II discusses the IRS rulings and court decisions that have attempted to define deferred compensation with respect to the employer's deduction. This approach is compared with that taken in the VEBA regulations in Part III. In Part IV, this Comment recommends that courts focus on the nature of the benefit in determining whether an employer should receive an immediate deduction and whether a VEBA should be tax-exempt. Alternatively, this Comment suggests that Congress consider the proposals released by the staff of the Joint Committee on Taxation, which set forth a bright-line rule based on the degree of deferral.

I. THE CODE

A. *Voluntary Employees' Beneficiary Associations: Section 501(c)(9)*

Section 501(a) of the Internal Revenue Code (the Code) exempts from federal income taxation organizations described under section 501(c).[19] Among them are VEBA's that meet the conditions of section 501(c)(9).[20] The Code succinctly describes VEBA's as:

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[18] Treas. Reg. § 1.501(c)(9)-3(f) (1980) (describing nonqualifying benefits). For further discussion of nonqualifying benefits, see *infra* note 24 and accompanying text.

[19] I.R.C. § 501(a). Section 501(a) also exempts religious and apostolic organizations, *see* I.R.C. § 501(d), and § 401(a) deferred compensation plans. However, exemption is denied if the primary purpose of the organization is to carry on a trade or business, *see* I.R.C. § 502, or if the organization engages in certain prohibited transactions, *see* I.R.C. § 503. Federal income tax is imposed upon business income unrelated to the exempt purpose of the the organization. I.R.C. §§ 511-515.

[20] I.R.C. § 501(c)(9). An excellent discussion of VEBA's is found in Cox, *Providing Benefits for Employees with Section 501(c)(9) Trusts Under the Final Regulations*, 39 INST. ON FED. TAX'N § 1.01 (ERISA Supp. 1981). *See generally* Brandenburg, *An Overview of the Reissued Proposed Regulations on Voluntary Employees' Beneficiary Associations*, 6 J. PENS. PLAN. & COMPLIANCE 395 (1980) (requirements in proposed regulations); Comm. on Pension & Profit-Sharing Trusts, *Legal Analysis*, *supra* note 14 (VEBA requirements and interaction with state law governing insurance); Curtiss, *supra* note 14 (VEBA requirements, deductibility of employer contributions and income tax treatment of employees); Dunkle, *Proposed Regulations for Voluntary Em-*

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> Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.[21]

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ployees' Beneficiary Associations - An Analysis, 58 TAXES 693 (1980) (requirements of VEBA's with discussion of nondiscrimination and control requirements); Dunkle, *Final Regulations*, *supra* note 14 (regulations highlighting unresolved areas); Glickman, *supra* note 16 (participation requirements, shareholder-employee participants, funding standards, and distinction between VEBA and deferred compensation plan); Greenblatt, *Tax Advantages*, *supra* note 14 (VEBA funding and deductibility of employer contributions); Greenblatt & Banoff, *Final Regs. Increase the Attractiveness of Voluntary Employees' Beneficiary Associations*, 54 J. TAX'N 194 (1981) (final regulations focusing on control and discrimination rules); Margolin, *Voluntary Employees' Beneficiary Associations Offer Substantial Benefits to Business*, 59 TAXES 763 (1981) (VEBA's including income and estate tax treatment); Powell & Schumaker, *supra* note 14 (VEBA's generally, deduction for employer's contributions, income tax effect on employees, and use of individual cash value policies to fund VEBA's); Stuchiner, *supra* note 14 (compares VEBA's with insured employee benefits plans and discusses tax consequences to employer and employee, application of state insurance law).

[21] I.R.C. § 501(c)(9). Congress first specifically provided for exemption of certain employee associations through VEBA's in 1928. Revenue Act of 1928, ch. 852, § 103(16), 45 Stat. 791, 814; *see also* H.R. REP. NO. 2, 70th Cong., 1st Sess. 13 (1928); S. REP. NO. 960, 70th Cong., 1st Sess. 25 (1928). The legislation was prompted by a decision of the Board of Tax Appeals, *see* Philadelphia & Reading Relief Ass'n, 4 B.T.A. 713 (1926), which held employee relief associations subject to federal taxation. Comm. on Pension & Profit-Sharing Trusts, *Legal Analysis*, *supra* note 14, at 666; Greenblatt, *New Prop. Regs.*, *supra* note 14, at 211. As originally enacted, the section described VEBA's that provided life, sick, accident, and other benefits subject to limitations including a requirements that 85% of the association's income be collected from members. Revenue Act of 1928, ch. 852, § 103(16), 45 Stat. 791, 814.

From 1928 to 1942, the section was carried forward without change. Section 103(16) was incorporated as § 101(16) of the Internal Revenue Code of 1939. After the Board of Tax Appeals held that tax exemption was precluded if employer contributions to VEBA's exceeded the 15% limitation on nonemployee contributions, *see* Shell Employees' Benefit Fund, 44 B.T.A. 452 (1941), Congress retroactively amended VEBA's to permit employer contributions to be treated as member contributions for purposes of the 85% test. Revenue Act of 1942, ch. 619, § 137(a), 56 Stat. 798, 836; *see also* S. REP. NO. 1631, 77th Cong., 2d Sess. 107 (1942) (expansion to alleviate hardship under then present law when employer willing to make contributions). One commentator suggests that employer contributions were permitted because of the increasing emphasis on employer financed fringe benefits in the wartime economy. Comm. on Pension & Profit-Sharing Trusts, *Legal Analysis*, *supra* note 14, at 667.

Section 101(16) of the 1939 Code became § 501(c)(9) of the 1954 Code. The provision on exemption was placed in § 501(a). The last amendment to § 501(c)(9), in 1969, deleted the requirement that 85% of contributions must be made by or on behalf of employee/members. Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(b)(5), 83 Stat. 487, 541.

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The regulations detail the qualification requirements for VEBA's.[22] This Comment focuses on the regulations defining qualifying[23] and

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[22] *See* Treas. Reg. § 1.501(c)(9)-1 (introduction), -2 (definition of terms including membership, employee, association, and voluntary), -3 (qualifying and nonqualifying benefits and permissible beneficiaries), -4 (prohibition against inurement), -5 (record-keeping requirements), -6 (inclusion of benefits in gross income), -7 (interaction with § 3(4) of the Employee Retirement Income Security Act of 1974), -8 (effective date) (1980).

Section 501(c)(9) and its predecessors were administered without regulations from 1928 to 1969. One commentator attributes the absence of regulations to the insignificant number of VEBA's prior to the 1960's. Greenblatt, *New Prop. Regs.*, *supra* note 14, at 211. In addition, the few existing VEBA's were generally composed, managed, and financed by small employee groups and provided very limited benefits. *Id.*

Proposed Regulations were first issued in 1969. Prop. Reg. § 1.501(c)(9)-1 (1969). The decision to promulgate regulations was prompted by changes in the labor law and the emergence of more numerous and sophisticated forms of fringe benefits. The Proposed Regulations were then withdrawn and replaced with new Proposed Regulations in 1980. This change was made because of the long period of time elapsing since publication of the 1969 Proposed Regulations, and because of the extensive revisions made to reflect comments received by the Service. Greenblatt, *New Prop. Regs.*, *supra* note 14, at 211. Final regulations were issued December 30, 1980. T.D. 7750, 1981-1 C.B. 338. The regulations remain unchanged to date.

[23] Treas. Reg. § 1.501(c)(9)-3(b) to -3(e) (1980). The regulations defining qualifying benefits are divided into three subsections covering separately i) life benefits, ii) sick and accident benefits, and iii) other benefits:

i) Treas. Reg. § 1.501-(c)(9)-3(b) (1980) describes life benefits. Generally, a life benefit means any benefit payable by reason of the death of a member or dependent, and the benefit may be provided directly or through insurance. The benefit must generally consist of current protection, but exceptions to this rule are provided. For further discussion of life benefits, see *infra* notes 149-65 and accompanying text.

ii) Treas. Reg. 1.501(c)(9)-3(c) (1980) describes sick and accident benefits. These benefits are amounts furnished in the event of illness or personal injury to a member or dependent, either directly or through insurance. Disability pay and preventative medical care are also included in the term sick and accident benefits. The benefits may be provided in cash, or in a noncash form such as medical services.

iii) Treas. Reg. § 1.501(c)(9)-3(d) (1980) sets forth the basic principles for determining the scope of the term other benefits. The regulation provides:

> The term "other benefits" includes only benefits that are similar to life, sick, or accident benefits. A benefit is similar to a life, sick, or accident benefit if—
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> (1) It is intended to safeguard or improve the health of a member or a member's dependents, or
>
> (2) It protects against a contingency that interrupts or impairs a member's earning power.

Id.

Treas Reg. § 1.501(c)(9)-3(e) (1980) lists examples of other benefits. These include vacation benefits, vacation facilities, recreational activities, child care facilities, job readjustment allowances, income maintenance payments in the event of economic disloca-

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nonqualifying[24] benefits. If an employees' organization provides nonqualifying benefits, it will not be treated as a tax-exempt VEBA under the Code.[25]

The regulations define the life, sick, accident, and other benefits VEBA's can fund.[26] Qualifying "other benefits" must either safeguard or improve the health of the member or her dependent,[27] or must protect against a contingency that impairs a member's earning power.[28] While an exhaustive list of examples of qualifying other benefits is given,[29] the determination of whether a particular benefit is qualifying must be made with reference to this basic standard.[30]

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tion, temporary living expense loans and grants at times of disaster, supplemental unemployment compensation benefits, severance benefits, education or training benefits or courses for members, certain personal legal service benefits and, except as otherwise provided in the regulations, any benefit provided in the manner permitted by the Labor Management Relations Act of 1947, § 302(c)(5), 61 Stat. 136, 157 (codified as amended at 29 U.S.C. § 186(c) (1976)). The only significant benefit the reference to the LMRA adds is educational benefits to members' dependents. Greenblatt, *New Prop. Regs.*, *supra* note 14, at 212. *But see infra* notes 141-48 and accompanying text (arguing that educational benefits should not qualify as VEBA benefits).

[24] Treas. Reg. § 1.501(c)(9)-3(f) (1980) provides examples of nonqualifying benefits. Generally, benefits not described as qualifying benefits are nonqualifying. Examples include commuting expenses, property insurance, malpractice insurance, the provision of loans to members except in times of distress, and provision of savings facilities to members. *Id.* Additionally, and of importance in this Comment, the regulation provides:

> The term "other benefits" does not include any benefit that is similar to a pension or annuity payable at the time of mandatory or voluntary retirement, or a benefit that is similar to the benefit provided under a stock bonus or profit-sharing plan. . . . [A] benefit will be considered similar to that provided under [the enumerated plans] if it provides for deferred compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event.

Id.

[25] An organization is not a VEBA if it "systematically and knowingly" provides more than de minimis benefits not permitted by the regulations. Treas. Reg. § 1.501(c)(9)-3(a) (1980). The Service has ruled that the determination of whether a benefit is de minimis depends on the relation of the nonqualifying benefit to the overall benefits provided by the association. LTR 8049012 (undated). Although private letter rulings and general counsel memoranda may not be used or cited as precedent, I.R.C. § 6110(j)(3), they are included in this Comment to illustrate the approach of the Service in particular fact situations.

[26] *See supra* note 23.

[27] Treas. Reg. § 1.501(c)(9)-3(e) (1980); *see supra* note 23.

[28] Treas. Reg. § 1.501(c)(9)-3(d) (1980); *see supra* note 23.

[29] Treas. Reg. § 1.501(c)(9)-3(d)(1) (1980).

[30] Treas. Reg. § 1.501(c)(9)-3(d)(2) (1980).

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Nonqualifying benefits include benefits similar to those provided by a pension, annuity, stock bonus, or profit-sharing plan.[31] The regulations state that a benefit will be considered similar to those provided by these enumerated plans if the benefit provides for deferred compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event.[32] However, beyond the nonqualifying plans specifically enumerated in the regulations, it is unclear what benefits the Service would consider deferred compensation.

While a VEBA that meets the regulation's requirements will be exempt from federal income tax,[33] the effect of employer contributions to a VEBA[34] and taxation of benefits provided by a VEBA[35] are governed by other sections of the Code.[36] The next section of this Comment discusses the deductibility of employer contributions to employee benefit plans.

B. *Employer's Deduction*

The Code distinguishes between employer contributions to plans that provide current welfare benefits and contributions to plans that provide deferred compensation.[37] If a plan does not provide deferred compensation, the employer can deduct contributions to the plan in the year paid or accrued. If deferred compensation is provided, the employer must either qualify its plan, or delay its deduction. The two code sections involved are discussed below.

1. Section 162: Currently Deductible Trade or Business Expenses

Section 162 of the Code allows a deduction for ordinary and necessary business expenses incurred in carrying on a trade or business,[38]

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[31] Treas. Reg. § 1.501(c)(9)-3(f) (1980); *see supra* note 24.

[32] Treas. Reg. § 1.501(c)(9)-3(f) (1980).

[33] I.R.C. § 501(a); *see supra* note 19.

[34] The deductibility of employer contributions to a VEBA is governed by the rules applicable to employer contributions to employee benefit plans and is discussed *infra* notes 37-49 and accompanying text.

[35] VEBA benefits provided to members are included in gross income to the extent provided by other Code sections. Treas. Reg. § 1.501(c)(9)-6 (1980); *see also infra* note 47 regarding income taxation.

[36] Boyers & Klein, *supra* note 14, at 48; Glickman, *supra* note 16, at 745.

[37] *See* Kelly, *supra* note 13, § 6.01, at 6-2, § 6.03, at 6-9.

[38] I.R.C. § 162(a). The seminal case interpreting the phrase "ordinary and necessary" was Welch v. Helvering, 290 U.S. 111 (1933) (whether expense is ordinary depends on time, place, and circumstance, but does not mean habitual or normal; necessary means appropriate and helpful to business; "[l]ife in all its fullness must supply

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including employee compensation.[39] Such expenses are deductible in the taxable year paid or incurred.[40] The regulations include amounts paid or accrued for employee benefit plans as deductible expenses.[41] However, the regulations further state that such amounts are not currently deductible under section 162 if the contributions could be used to provide benefits under a stock bonus, pension, annuity, profit-sharing, or other deferred compensation plan of the type referred to in section 404(a). In such circumstances, the employer's contributions are only deductible to the extent permitted under section 404 of the Code.[42] Section 162 and the regulations thereunder do not clearly define the type of deferred compensation plans excluded from its coverage, other than the enumerated plans. The regulations merely cross-reference to section 404 for further elaboration.[43] An analysis of section 404 is, therefore, necessary to determine what types of plans are deductible under section 162.

2. Section 404: Contributions to Deferred Compensation Plans

Section 404 governs the deductibility of contributions made by an employer under a pension, annuity, stock bonus, or profit-sharing plan, and under any plan of deferred compensation.[44] If a deferred compensation plan is qualified under section 401(a),[45] contributions are deductible in the taxable year paid.[46] However, if the plan is not qualified

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the answer").

[39] I.R.C. § 162(a)(1) (reasonable allowance for salaries or other compensation for personal services).

[40] I.R.C. § 162. If the taxpayer uses the cash method of tax accounting, deductions are allowed in the taxable year in which the expense is paid. *See* I.R.C. § 461(a); Treas. Reg. § 1.461-1(a)(1), T.D. 6917, 1967-1 C.B. 108, 109. Under the accrual method of accounting, an expense is generally deductible in the taxable year in which all the events have occurred that determine the fact and amount of liability with reasonable accuracy. Treas. Reg. § 1.461-1(a)(2), T.D. 6917, 1967-1 C.B. 108, 109.

[41] Treas. Reg. § 1.162-10(a) (1960). Specifically, the regulations include amounts paid or accrued for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, medical expenses, and recreational, welfare, or similar benefit plans provided the amounts are ordinary and necessary expenses of the trade or business. *Id.*

[42] *Id.*; *see infra* notes 44-49 and accompanying text.

[43] Treas. Reg. § 1.162-10(c) (1960).

[44] I.R.C. § 404(a); Treas. Reg. § 1.404(a)-1(a)(1), T.D. 6676, 1963-2 C.B. 41, 66-67.

[45] *See supra* note 12.

[46] I.R.C. § 404(a)(l) - (4); Treas. Reg. § 1.404(a)-3, T.D. 7168, 1972-1 C.B. 118, 119; Treas. Reg. 1.404(a)-8, T.D. 7501, 1977-2 C.B. 133, 135-36; Treas. Reg. § 1.404(a)-9, T.D. 6534, 1961-1 C.B. 145, 150-51. Note that the contribution is de-

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under section 401(a), section 404(a)(5) precludes deduction of the contribution until the year an amount attributable to the contribution is includable in the gross income of the participating employee.[47] The reg-

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ductible only in the taxable year paid, even if the taxpayer uses the accrual method of tax accounting for other purposes.

[47] I.R.C. § 404(a)(5); Treas. Reg. § 1.404(a)-12, T.D. 7554, 1978-2 C.B. 71, 91-92. If more than one employee participates in the plan, the contribution is deductible only if separate accounts are maintained for each employee. Treas. Reg. § 1.404(a)-12(b)(3), T.D. 7554, 1978-2 C.B. 71, 91-92. Section 404(a) is not limited in its application to formal plans, but encompasses any method of contribution having the effect of a deferred compensation plan. I.R.C. § 404(b); Treas. Reg. § 1.404(b)-1 (1960).

An in-depth analysis of taxation of employee benefits is beyond the scope of this Comment. However, because inclusion of a benefit in the employee's income can affect the timing of the employer's deduction, some general information on taxation of benefits is helpful.

The general rule of taxation is that gross income includes all income from whatever source derived. *See* Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) (gross income includes all realized gains or accession to wealth except those specifically exempted); Treas. Reg. § 1.61-2, T.D. 7623, 1979-1 C.B. 66, 73 (examples of items included in gross income). Gross income need not be paid in cash, but may be in the form of property or services. Treas. Reg. § 1.61-1(a) (1960).

Many employee welfare benefits are excluded from gross income under current tax law. *See, e.g.*, I.R.C. § 79 (group term life insurance); I.R.C. § 101(b) (employee death benefits); I.R.C. §§ 104(a)(3), 105(b), 106 (medical insurance or reimbursement); I.R.C. § 120 (group legal services); I.R.C. § 129 (dependent care assistance). Controversy exists regarding the taxation of employee fringe benefits as compensation. *See generally* Finneran, *supra* note 11 (proposing that IRS tax fringe benefits to full extent permitted unless benefit satisfies test of job-related nexus and employment-related use); Kreiser, *A New Standard for Determining the Tax Treatment of Nonstatutory Fringe Benefits*, 7 REV. TAX'N INDIV. 158 (1983) (recommending inclusion of fair market value of all nonstatutory fringe benefits to extent value of benefits exceeds 6% of employee's personal service income, with statutory floor and ceiling); Popkin, *The Taxation of Employee Fringe Benefits*, 22 B.C.L. REV. 439 (1981) (recommending that exemption of fringe benefits from income depend on existence of cash option in cafeteria plan, and that fringe benefits provided to controlling and high income employees be selectively taxed). The Treasury Department issued a discussion draft of proposed regulations governing fringe benefits in 1975, Fringe Benefits, Notice of Publication of Discussion Draft of Regulations and Proposed Treasury Regulation § 1.61-16, 40 Fed. Reg. 41,118 (1975); *see also* OFFICE OF THE ASSISTANT SECRETARY FOR TAX POLICY, DEP'T OF THE TREASURY, SUMMARY AND EXPLANATION OF DISCUSSION DRAFT OF PROPOSED REGULATIONS ON FRINGE BENEFITS (Sept. 2, 1975), which was later withdrawn, 41 Fed. Reg. 56,331 (1976). Presently, the Treasury's rulemaking authority over fringe benefits is suspended by Congress. Economic Recovery Tax Act, Pub. L. No. 97-34, § 801, 95 Stat. 172, 349 (1981); Fringe Benefits Act, Pub. L. No. 96-167, § 1, 93 Stat. 1275, 1275 (1979); Fringe Benefits Act of Oct. 7, 1978, Pub. L. No. 95-427, § 1, 92 Stat. 996, 996 (1978); *see also* S. REP. NO. 433, 96th Cong., 1st Sess. 3-5, *reprinted in* 1979 U.S. CODE CONG. & AD. NEWS 2594, 2596-98; H.R. REP. NO. 1232, 95th Cong., 2d Sess. 3-5, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS

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ulations under section 404 state that the section does not apply to con-

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2508, 2509-10.

If a benefit is not excluded from gross income by statute, the timing of inclusion becomes important. Generally, income is taxed in the year received. I.R.C. § 451(a). However, contributions to an employee benefit plan are made before actual payment of the benefit. Income could be taxed prior to distribution from the plan under several overlapping doctrines which have application in the employee benefits area.

Under the doctrine of constructive receipt, income is deemed received in the taxable year in which it is credited to the taxpayer's account or otherwise made available without substantial limitation or restriction. Treas. Reg. § 1.451-2(a), T.D. 7663, 1980-1 C.B. 101, 103. If an employee is not entitled to withdraw funds credited to her account until a later time, such funds are not constructively received. *Id.* Many fringe benefits are subject to some condition at the time of employer contribution precluding constructive receipt. For example, benefits payable only in the event of involuntary unemployment are not constructively received until the employee becomes unemployed. *See generally* Rev. Rul. 60-31, 1960-2 C.B. 1010; Metzer, *Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation*, 29 TAX L. REV. 525, 529-50 (1974).

Under the economic benefit theory, a benefit that has an ascertainable fair market value is included in gross income at the time the value of the benefit is realized. *See* Commissioner v. Smith, 324 U.S. 177 (1945); Metzer, *supra*, at 550. In contrast to the doctrine of constructive receipt, which focuses on *when* income is taxed, the economic benefit theory examines *what* property rights should be taxed. Metzer, *supra*, at 551. Provision of benefits under a plan often provides an economic benefit to the employee although she may receive no actual payment. For instance, life insurance coverage has economic value before payment of the death benefit. Thus, unless the benefit is statutorily excluded from income, an employee arguably should be taxed when the employer contributes to the plan, to the extent the employee realizes value from the benefit. *See generally* Metzer, *supra*, at 550-82.

Section 83 of the Code codified and expanded the economic benefit theory. *See* Metzer, *supra*, at 552. Although § 83 is most applicable to nonqualified stock options, one commentator has suggested that it applies to all taxable fringe benefits. Nolan, *Deferred Compensation and Employee Options Under the New Section 83 Regulations*, 57 TAXES 790, 791 (1979). The value of property transferred in connection with the performance of services is included in income, pursuant to § 83, in the year the rights to such property are transferable or when the rights are not subject to a substantial risk of forfeiture. I.R.C. § 83(a); *see also* I.R.C. § 83(c)(2) (rights to property transferable when not subject to substantial risk of forfeiture); I.R.C. § 83(c)(1) (property subject to substantial risk of forfeiture if rights in transferred property conditioned upon future performance of services or occurrence of condition related to purpose of transfer). Although property includes a beneficial interest in trust assets, *see* Treas. Reg. § 1.83-3(e) (1978), the existence of a contingency that must occur before payment of a benefit, such as a requirement that an employee become involuntarily unemployed before payment of supplemental unemployment benefits, would preclude employee taxation under § 83 at the time the employer contributes to the trust. *See* Treas. Reg. § 1.83-3(c)(1) (1978). Similarly, if future services are required before the benefit is payable, § 83 would not apply to tax the benefits until the services were rendered. *See* Salem & Schmalbeck, *Group-Term Life Insurance: IRS Creates New Solutions, Questions and Challenges*,

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tributions under a plan that provides *solely* dismissal wages, medical expenses, recreation, welfare, or similar benefits.[48] Therefore, if a plan provides deferred compensation, the fact that it also provides welfare benefits will not remove it from the reach of section 404.[49]

In summary, a benefit that defers compensation is a nonqualifying benefit under section 501(c)(9), and an employees' organization providing such a benefit will not be treated as a tax-exempt VEBA. If the employer makes a contribution to a plan that provides deferred compensation, as defined in section 404, the contribution is not currently deductible under section 162, but is deductible only to the extent permitted under section 404. Further, unless the contribution is made to a qualified section 401(a) plan, it is not deductible until the employee includes the compensation in gross income. Thus, aside from those qualified section 401(a) plans, the Code treats plans that provide deferred compensation in a significantly different manner from those that do not.

II. THE EMPLOYER'S DEDUCTION AND DEFERRED COMPENSATION: A LOOK AT SELECTED BENEFIT PLANS

This Part examines the attempts of the IRS and the courts to define deferred compensation in the context of four different benefit plans: severance pay plans, vacation pay plans, educational benefit trusts for dependents, and retired lives reserves. The first three types of plans

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51 J. TAX'N 130, 133 n.15 (1979) (suggesting § 83 would not tax employees on contributions to retired lives reserves if plan required continuation with employer until retirement to receive post-retirement insurance coverage).

If the employer contributes to a qualified deferred compensation plan, *see supra* note 12, recognition of income will be deferred (although not excluded) until actual distribution of the benefits. I.R.C. § 402(a). This is true even if the employee's rights to the employer's contributions are nonforfeitable. *See* Treas. Reg. § 1.402(a)-1(a)(1)(i), T.D. 6887, 1966-2 C.B. 129, 130. If contributions are made to a nonqualified deferred compensation plan, the employee recognizes income in accordance with § 83. I.R.C. § 402(b). To the extent the employee's interest in the contribution is substantially vested, compensation is included in taxable income in the year the employer contributes to the plan. *See* Treas. Reg. § 1.402(b)-1(a)(1), T.D. 7554, 1978-2 C.B. 71, 85-88.

[48] Treas. Reg. § 1.404(a)-1(a)(2), T.D. 6676, 1963-1 C.B. 41, 66-67.

[49] Treas. Reg. § 1.404(a)-1(a)(3), T.D. 6676, 1963-1 C.B. 41, 66-67. Section 83 of the Code, discussed *supra* note 47 in the context of income taxation, also governs the timing of an employer's deduction under some circumstances. *See* I.R.C. § 83(h); Treas. Reg. § 1.83-6 (1978). However, transfers to employee benefit plans described in either Treas. Reg. § 1.162-10(a) (1960) or I.R.C. § 404(a)(5) are not subject to § 83. Treas. Reg. § 1.83-6(a)(3) (1978). Because the nonqualified plans discussed in this Comment would fall within that exception, § 83(h) is not further discussed herein.

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have been the subject of litigation developing a definition of deferred compensation in the context of the employer's deduction.[50] Retired lives reserves are uncharted in the courts, but have been addressed by the Service.[51]

A. *Severance Pay and Supplemental Unemployment Benefits*

Severance pay is a benefit paid to employees at employment termination, generally to provide temporary monetary assistance between jobs.[52] Supplemental unemployment benefits, as the name suggests, are payments to supplement state unemployment benefits.[53] The employer's contributions to plans paying these types of benefits are generally deductible at the time paid or accrued.[54] However, the IRS has ruled that if severance or supplemental unemployment benefits are payable at retirement, or are paid to all employees regardless of the reason for termination, then these benefits represent deferred compensation and section 404 governs the employer's deduction.[55] If such a plan is not qualified under section 401(a),[56] the employer may not deduct its contributions until the employee includes the benefit in income, and may only take the deduction then if separate accounts were maintained for each employee.[57]

The Tax Court first considered the issue of when severance pay constitutes deferred compensation in *New York Post Corp. v. Commis-*

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[50] Greensboro Pathology Assocs. v. United States, 698 F.2d 1196 (Fed. Cir. 1982) (educational benefit trusts); Grant-Jacoby, Inc. v. Commissioner, 73 T.C. 700 (1980) (educational benefit trusts); Citrus Orthopedic Medical Group v. Commissioner, 72 T.C. 461 (1979) (educational benefit trusts); Latrobe Steel Co. v. Commissioner, 62 T.C. 456 (1974) (vacation benefits); New York Seven-Up Bottling Co. v. Commissioner, 50 T.C. 391 (1968) (severance pay); New York Post Corp. v. Commissioner, 40 T.C. 882 (1963) (severance pay).

[51] *See infra* note 116.

[52] Boyers & Klein, *supra* note 14, at 58.

[53] *See* Kelly, *supra* note 13, § 6.04(3), at 6-19.

[54] Amounts paid or accrued for dismissal wages and unemployment benefits are deductible under § 162(a) if they are ordinary and necessary expenses of the trade or business, so long as they cannot be used to provide benefits under a deferred compensation plan. Treas. Reg. § 1.162-10(a) (1960).

[55] *See* Rev. Rul. 81-17, 1981-1 C.B. 75 (amounts paid as lump sum at separation from employment, including separation for retirement, constitute deferred compensation, and employer's deduction governed by § 404(a)(5)); Rev. Rul. 57-37, 1957-2 C.B. 18 (if layoff and disability benefits are vested in and nonforfeitable by employee, and paid upon retirement or termination, employer's deduction governed by § 404(a)(5)).

[56] *See supra* note 12.

[57] Rev. Rul. 57-37, 1957-2 C.B. 18, 21.

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sioner.[58] The *New York Post* paid severance benefits to employees who were dismissed or discharged, or when employees had completed twenty-five years of service or had attained age sixty-five.[59] The *Post* claimed a deduction for its accrued liability for the severance pay.[60] The court noted that while not all payments to employee benefits plans are deferred compensation,[61] Congress was particularly concerned when enacting section 404 about payments in the nature of retirement benefits. The Tax Court held that both the age provision and the minimum number of years of service required by the *Post*'s plan justified treating the severance pay as retirement benefits.[62] The amounts accrued for severance pay constituted contributions to a plan deferring the receipt of compensation within the meaning of section 404,[63] which precluded deduction until such amounts were actually paid to the employee.[64]

Five years later, the Tax Court reexamined the issue of severance pay as deferred compensation in *New York Seven-Up Bottling Co. v. Commissioner*.[65] Seven-Up paid severance benefits at discharge or vol-

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[58] 40 T.C. 882 (1963).

[59] *Id.* at 882, 884. Severance benefits were also paid upon the death of an employee. *Id.* at 885.

[60] *Id.* at 882, 885. The *Post* had maintained books reflecting its anticipated liability for severance pay for employees who had reached age 65 or completed 25 years of service, and sought to deduct the anticipated amounts, claiming that its liabilities were fixed. *Id.* at 885. The Service argued that various contingencies prevented accrual of the liabilities, and that, in any event, § 404 precluded deduction of the accrued amounts, even if otherwise proper. *Id.* at 886; *see also infra* note 65 (deduction of accrued liability for plan).

[61] *Id.* at 888. This was supported by the exclusion in the regulations of certain welfare benefits from application of § 404(a). *See supra* notes 48-49 and accompanying text.

[62] 40 T.C. at 889-90.

[63] *Id.* at 887. The court also found that, as the payments were not solely dismissal wages, Treas. Reg. § 1.404-1(a)(2) did not preclude application of § 404(a). *New York Post*, 40 T.C. at 888-89.

[64] *Id.* at 890.

[65] 50 T.C. 391 (1968). In this case, the employer had initially provided a severance pay benefit on termination of employment pursuant to a collective bargaining agreement. *Id.* at 393. When, pursuant to a subsequent collective bargaining agreement, the severance pay plan was frozen and a retirement plan established, the employer deducted the total amount of liabilities accrued under the severance pay plan. *Id.* at 395.

The issue of whether a particular benefit constitutes deferred compensation should not be confused with the issue of when a contingent liability is deductible with regard to a benefit that is not deferred compensation. If a plan provides deferred compensation, a deduction is permitted only when the contribution or benefit is paid. I.R.C. § 404(a). However, contributions to benefit plans, such as the severance pay plan discussed in *New York Seven-Up*, if determined not to provide deferred compensation, are deductible

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untary resignation.[66] Conceding that its severance pay was deferred compensation, Seven-Up argued that section 404(a) applied only to the types of plans enumerated therein. The court rejected this argument, finding that application of section 404(a) was not limited to plans that are similar to pension, stock bonus, profit-sharing, and annuity plans.[67] Because Seven-Up's plan assured some benefit to all employees, the court held that section 404(a) applied, and disallowed current deduction of contributions.[68] This reasoning expanded *New York Post*, as it focused not on the nature of the benefit as retirement income, but on the fact that all employees would ultimately receive some benefit from the plan.

A federal district court[69] addressed a similar definitional issue in

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when paid or accrued. I.R.C. § 162; Treas. Reg. § 1.162-10 (1960). Thus, litigation in some cases has focused on whether an expense has accrued for tax purposes, particularly if the employer's liability to pay the benefit is conditioned on some future event. *See, e.g.*, Inland Steel Co. v. United States, 677 F.2d 72, 77-79 (Ct. Cl. 1982) (taxpayer entitled to deduct contingent liabilities accrued under supplemental unemployment benefit plan); Lukens Steel Co. v. Commissioner, 52 T.C. 764, 785-86 (1969) (deduction allowed under I.R.C. § 162 when contingent liability for supplemental unemployment benefit plan fixed as to existence and amount, and ultimate payment reasonably certain). *But see* Rev. Rul. 72-34, 1972-1 C.B. 132 (IRS will not follow *Lukens* because liability cannot be fixed under all-events test if a contingency exists as to payment of obligation). The Reagan administration has proposed to key the all-events test to occurrence of economic performance or satisfaction of liability. JOINT COMM. PROPOSALS, *supra* note 1, at 70.

[66] An employee must have had five years of continuous service with the company to be entitled to the benefits. *New York Seven-Up*, 50 T.C. at 393-94.

[67] *Id.* at 398. The court also rejected the taxpayer's argument that § 404(a) was limited to retirement benefits. *Id.* at 396.

[68] *Id.* at 398. The taxpayer also argued that § 404(a) did not apply to its severance pay plan by reason of Treas. Reg. § 1.404(a)-1(a)(2), which precludes application of § 404(a) to a plan that is solely a dismissal wage, unemployment benefit, welfare, or similar benefit plan. *Id.* at 397. However, the court noted that Treas. Reg. § 1.404(a)-1(a)(2) was qualified by Treas. Reg. § 1.404(a)-1(a)(3). The court interpreted the latter subparagraph as requiring that a plan that assures some benefit to all participants is subject to § 404(a) even if the plan also provides some of the benefits in the former subparagraph. *New York Seven-Up*, 50 T.C. at 397-98. The court then held that § 404(a)(5) prohibited deduction until the year benefits were paid to employees. *Id.*

[69] An income tax litigant can elect not to pay a deficiency asserted by the Service and sue in the United States Tax Court, or pay the tax and sue in either a federal district court or the Claims Court. Appeal from either the Tax Court or a federal district court is taken to a circuit court of appeals, while appeal from a decision of the Claims Court is taken to the Court of Appeals for the Federal Circuit. One commentator has suggested that these multifarious routes to tax litigation increase confusion in an already complex field. *See* Ginsberg, *Making Tax Law through the Judicial Process*, 70 A.B.A. J., Mar. 1984, at 74, 74-77 (1984).

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Lundy Packing Co. v. United States.[70] Lundy Packing accrued annual sick pay for its employees, payable when an employee was absent from work as a result of illness. Any balance remaining in the account was paid to the employee at termination of employment.[71] The court rejected Lundy Packing's attempt to deduct the accrued amounts under section 162, finding that the plan provided not only sick pay, but also deferred compensation within the meaning of section 404.[72] Like the Tax Court in *New York Seven-Up*, the district court found it significant that all employees were assured additional deferred compensation.[73]

After these three cases, it appeared that the scope of deferred compensation was not limited to the types of plans enumerated in section 404. Although *New York Post* focused on the similarity of a severance pay plan to a retirement plan,[74] both *New York Seven-Up* and *Lundy Packing* found it more significant that all employees would ultimately receive some benefit from the plan, regardless of whether or not the

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[70] 302 F. Supp. 182 (E.D.N.C. 1969), *aff'd per curiam*, 421 F.2d 850 (4th Cir. 1970).

[71] *Lundy Packing*, 302 F. Supp. at 183. The employer in *Lundy* did not pay contributions to a sick pay plan, but accrued sick pay to the account of each employee. The accrued amounts were not maintained in a separate fund, but were a part of the employer's general cash account. Termination of employment included retirement and death. *Id.* at 183-84.

[72] *Id.* at 186. Although some of the amounts accrued were paid out for sickness, the court noted that a substantial amount of compensation unrelated to sick pay benefits was deferred. *Id.* at 187-88. Thus, Treas. Reg. § 1.404(a)-1(a)(2) did not apply to preclude application of § 404(a). *Id.* at 186-87. *Compare* Lundy Packing Co. v. United States, 302 F. Supp. 182 (E.D.N.C. 1969), *aff'd per curiam*, 421 F.2d 850 (4th Cir. 1970) *with* Zwicker Knitting Mills v. United States, 47 A.F.T.R.2d (P-H) ¶ 81-310, at 81-339 to 81-340 (1980) (contributions accrued to plan which covered the cost of annual physical exams and similar social benefits for employees deductible under § 162).

[73] *Lundy Packing*, 302 F. Supp. at 188. Another factor considered by the court was that the amounts accrued to the sick pay accounts had not been set aside in a separate fund. Because there was no guarantee that employees would receive their benefits, the employer had little justification in deducting the amounts accrued. *Id.* at 186.

Another federal district court reached the same result in Presto Prod. v. United States, 571 F. Supp. 1171 (N.D. Ga. 1983). Presto accrued contributions to a sick pay plan and permitted its employees to accumulate sick leave. The accumulated sick leave could be taken as general leave or was paid on termination of employment. *Id.* at 1172. Granting the government's motion for summary judgment, the court held that Presto's deduction was governed by § 404 and was not deductible when accrued under § 162. The court expressly followed the *Lundy Packing* reasoning. *Presto*, 571 F. Supp. at 1173; *see also Sick Leave Plan Held a Deferred Compensation Plan*, 3 A.B.A. SEC. TAX'N NEWSLETTER 15, 16 (1984) (discussing *Presto*'s application to funded sick pay plans and VEBA's).

[74] *New York Post*, 40 T.C. at 888, 890.

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employee had met the contingency for which the plan was designed.[75] However, the Tax Court withdrew from this approach when it considered vacation benefits.

B. Vacation Benefits

Employers often provide vacation pay for employees by paying or accruing contributions to a plan that distributes vacation pay to eligible employees. Generally, contributions paid to such a plan are deductible under section 162.[76] However, if the plan permits or requires accumulation or accrual of vacation benefits over an extended period of time, the vacation benefit arguably constitutes deferred compensation.

The Tax Court considered whether such an extended vacation benefit constituted deferred compensation in *Latrobe Steel Co. v. Commissioner*.[77] Latrobe had adopted an extended vacation plan that entitled each qualifying employee to take up to thirteen weeks of paid vacation once every five years. Vacation benefits vested under criteria set out in the plan, and once vested, were nonforfeitable and payable in the event of death or termination of employment.[78] The Service argued that the vacation plan deferred the receipt of compensation within the meaning of section 404(a).[79] After examining the legislative history of section 404,[80] the court extended its literal meaning to conclude that a plan

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[75] *Lundy Packing*, 302 F. Supp. at 186-88; *New York Seven-Up*, 50 T.C. at 398.

[76] Treas. Reg. § 1.162-10(a) (1960). *But see* I.R.C. § 463 (limiting deductible accrued vacation); *infra* note 82.

[77] 62 T.C. 456 (1974).

[78] Vesting of extended vacation benefits was determined by the date on which employees were eligible for regular vacation benefits. *Id.* at 457-58.

[79] *Id.* at 462. The Service argued that § 404(a) applied whenever compensation is paid under a plan that has the effect of deferring any compensation. The taxpayer contended, conversely, that § 404(a) applied only to stock bonus, pension, profit-sharing, or annuity plans, or similar plans that defer the receipt of compensation. The taxpayer argued that the vacation plan at issue was not similar to the enumerated plans, and therefore § 162, not § 404(a), applied. *Id.*

[80] *Id.* at 462-64. The court examined § 23(p) of the Internal Revenue Code of 1939, as amended by the Revenue Act of 1942 (the predecessor to § 404(a)), and concluded that the legislative history established that § 404 was applicable only to the four enumerated plans and similar plans. *Id.* at 463. As originally introduced, § 23(p) was limited to stock bonus, pension, profit-sharing, annuity, and similar plans deferring the receipt of compensation. *Latrobe*, 62 T.C. at 462-63; *see* H.R. 7378, 77th Cong., 2d Sess. 113-16 (1942). Although the final version of § 23(p) deleted the words "similar plan," the court found that this change was not intended to extend the application of § 23(p), but was made for technical reasons relating to the uniformity of language in the Code. *Latrobe*, 62 T.C. at 464; *see also* S. Rep. No. 1631, 77th Cong., 2d Sess. (1942).

The court found additional support for its conclusion in the retention of the phrase

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that defers the receipt of compensation is subject to section 404(a) only if it is *similar to* the pension, profit-sharing, stock bonus, or annuity plans enumerated therein.[81] The extended vacation plan at issue was not substantively similar to the enumerated plans,[82] which precluded application of section 404 and permitted deduction of the employer's contributions under section 162.[83]

Latrobe distinguished the severance pay plan in *New York Seven-Up* from the vacation pay plan before it by the Seven-Up plan's similarity to a pension plan. However, to the extent that *New York Seven-Up* held that section 404(a) was not limited to plans that are similar to pension, profit-sharing, stock bonus, or annuity plans, *Latrobe* overruled *New York Seven-Up*.[84] The Service indicated its nonacquiescence in *Latrobe*,[85] and awaited the next round of litigation, which centered on the deductibility of contributions to educational benefit trusts.

"similar plan" in § 23(p)(1), governing deductions for methods of contributions having the effect of a plan. *Latrobe*, 62 T.C. at 464. The court reasoned that if § 23(p)(1) were limited to plans similar to the enumerated plans, and § 23(p) was not so limited, a plan not similar to the enumerated plans could escape the deduction limitations of § 404, if the plan were transformed from a plan to a method of contributions having the effect of a plan. *Id.* It should be noted, however, that § 404(b) of the 1954 Code (the successor to § 23(p)(1)) no longer contains the phrase "similar plan." *See infra* notes 109-11 and accompanying text. This omission removes at least part of the basis for the court's holding in *Latrobe*.

[81] *Latrobe*, 62 T.C. at 464-65.

[82] *Id.* The court reasoned that the substance of pension and annuity plans is the provision of actuarially determined benefits to employees upon retirement. Profit-sharing and stock bonus plans are designed to grant employees a share of the employer's profits. Although *Latrobe*'s extended vacation plan resulted in deferred compensation, the court noted that it was designed neither to provide benefits to employees upon retirement, nor to grant employees a share of the employer's profits. Therefore, the vacation plan was not substantively similar to the plans enumerated under § 404. *Id.*

As further support for this conclusion, the court pointed to the historical treatment of vacation pay by the Service and Congress. The court noted that prior Treasury rulings had not treated vacation pay plans as deferred compensation plans, but rather had allowed employers to accrue vacation pay, contrary to the limitations of § 404. Congress had acquiesced in treating accrued vacation pay as deductible under § 162, and had not acted to limit deduction to certain types of vacation pay. *Id.* at 465-66. However, deductible accrued vacation pay is now limited to vacation pay earned in one year and payable within 12 months following the end of the taxable year earned. I.R.C. § 463(a).

[83] *Latrobe*, 62 T.C. at 467.

[84] *Id.*

[85] *Nonacq.*, 1976-2 C.B. 3.

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C. Educational Benefit Plans

Educational benefit plans consist of employer contributions to a trust that makes distributions to qualified employees or their dependents upon attendance at an educational institution.[86] The Service has ruled that employer contributions to an educational benefit plan for dependents represent deferred compensation deductible only when an amount attributable to the contribution is included in the gross income of the employee.[87]

In *Citrus Orthopedic Medical Group v. Commissioner*,[88] the Tax Court first considered the circumstances under which employers could deduct contributions to educational benefit plans. Citrus funded individual accounts for the children of key employees, and paid cash benefits to the children when they attended a college or university.[89] The Tax Court held that Citrus's educational plan provided deferred compensation within the meaning of section 404(a), focusing on the fact that Citrus's sole two shareholders and key employees controlled the trust and used it to discharge their parental responsibilities for the college education of their children.[90] The court viewed the trust as an at-

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[86] *See* Bromberg, *Do Educational Benefit Trusts Make Tax Sense?*, 6 REV. TAX'N INDIV. 351, 351 (1982); Comment, *Federal Income Taxation of Educational Benefit Trusts*, 51 NOTRE DAME LAW. 303, 303 (1975) [hereafter Comment, *Educational Benefit Trusts*].

[87] Rev. Rul. 75-448, 1975-2 C.B. 55. The ruling follows a three step analysis. First, contributions to educational benefit plans are considered compensation, at least when contributed on the basis of the parent's employment and earnings record. Second, because the plan does not distribute benefits until the child of a qualified employee attends an educational institution, the receipt of compensation is deferred. Finally, unless the plan is qualified under § 401(a), employer contributions are deductible under § 404(a)(5) only when the employee recognizes income. *Id.* at 56. The ruling also provides that income is taxed to the parent/employee under § 83 if the child incurs qualifying educational expenses while the parent is still employed by the contributing employer. *Id.* at 57.

[88] 72 T.C. 461 (1979).

[89] *Id.* at 462. Funds in the individual accounts were forfeited if the parent terminated employment, or if the child did not enroll in an educational institution. *Id.* at 463.

[90] *Id.* at 467-68. The court first held that Citrus's contributions had not been paid or incurred within the meaning of § 162(a). *Id.* at 467. The court noted that the two doctors who provided Citrus with its principal source of income were the sole shareholders, the only key employees, and the only members of the committee with full authority over the trust. *Id.* at 463-64. Because Citrus could amend or terminate the trust at any time, it retained full control over the contributed funds. *Id.* at 464-66. The court therefore concluded that the rights purportedly conferred on children of key employees were illusory, as the contributions did not undergo a "substantial change in

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tempt to defer the receipt and taxation of income until it was needed.[91] This deferral was held to be similar in principle to a section 404(a) profit-sharing plan, and thus was governed by that section and not deductible under section 162.[92]

The Tax Court had an opportunity to reconsider educational benefit plans in *Grant-Jacoby, Inc. v. Commissioner.*[93] In discussing whether Grant-Jacoby's contributions to the plan were deductible under section 404(a) or section 162,[94] the court noted that it had previously concluded

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economic ownership." *Id.* at 464.

[91] *Id.* at 468. The court dismissed as "border[ing] on the ludicrous" the employer's argument that transfers to the trust represented noncompensatory fringe benefits. *Id.* at 468-69. The finding that contributions constituted compensation to the parents is further supported by Armantrout v. Commissioner, 570 F.2d 210 (7th Cir. 1978), *aff'g per curiam* 67 T.C. 996 (1977).

Armantrout involved an educational benefit plan similar to that in *Citrus.* The issue involved was who, as between the employee/parent and the child attending school, was taxed on distributions from the plan. *Id.* at 211-12. In holding that the employee was taxed, *Armantrout* stressed that the purpose of the plan was to compensate employees. *Id.* at 212-13. The plan payments were included in the employee/parent's gross income under either § 61 or § 83. *Id.* at 212 n.4; *see supra* note 47. For further analysis of the issues raised by *Armantrout*, see Lowe, *Treatment of Educational Benefit Plan Contributions After the* Greensboro *Decision*, 58 J. TAX'N 330, 332-33 (1983); Shores, *Educational Benefit Trusts — Another View*, 56 TAXES 379 (1978) (concurring with result in *Armantrout* but arguing that proper basis for taxing parent was not assignment of income doctrine, but economic benefit theory); Teschner, *The First Educational Benefit Trust Case*, 56 TAXES 255 (1978) (criticizing *Armantrout*); Comment, *Educational Benefit Trusts*, *supra* note 86, at 318-21 (analyzing educational benefit trusts as noncompensatory fringe benefits versus compensation; incidence of tax on distributions); *cf.* LTR 8137001 (undated) (when educational benefits characterized as loan, employee still taxed if no good faith intent to repay).

[92] *Citrus*, 72 T.C. at 468. The court found that Citrus had simply set aside part of its profits for the later education of its key employees' children in a manner similar to the operation of a profit-sharing plan. *Latrobe* was distinguished in that it involved a collectively bargained vacation plan that was not similar to the plans enumerated in § 404(a). *Id.*

[93] 73 T.C. 700 (1980). Grant-Jacoby had adopted an educational benefit plan as a means of remaining competitive in the industry, attracting new talent, and maintaining the loyalty of its important employees. *Id.* at 702. The plan, like the one in *Citrus*, covered only children of key employees who were attending an accredited school while their parents were employed by Grant-Jacoby. *Id.* at 703-04.

[94] *Id.* at 710. Although the court noted that § 83(h) was possibly applicable to benefits received under an education benefit plan, it restricted its analysis to the issue of whether § 162 or § 404(a)(5) applied. *Id.* at 710-11; *see also supra* note 49.

The court first discussed the incidence of tax on distributions made under the plan, and concluded that the employee/parents were taxed. *Id.* at 706-10. In so holding, the court relied upon Armantrout v. Commissioner, 570 F.2d 210 (7th Cir. 1978), *aff'g per curiam* 67 T.C. 996 (1977) (discussed *supra* note 91). The *Grant-Jacoby* court

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that section 404 was not intended to apply to all plans resulting in the deferral of compensation, but only to plans similar to stock bonus, pension, profit-sharing, or annuity plans.[95] The court found it significant that Grant-Jacoby's plan benefited only owner/employees, and stated that in such circumstances there is more reason to delay deduction until benefits are distributed.[96] Because Grant-Jacoby's educational benefit plan was similar to a section 404(a) profit-sharing plan, the deductibility of contributions was limited by section 404(a)(5).[97]

The Court of Appeals for the Federal Circuit[98] reached a different result in *Greensboro Pathology Associates v. United States*[99] with respect to a plan that benefited all employees rather than owner/employees.[100] *Greensboro* analyzed the employer's deduction by distinguishing welfare or similar benefit plans deductible under section 162 from deferred compensation of the type referred to in section 404(a).[101] Noting that all types of fringe benefits have an element of deferred receipt of compensation, the court held that the relevant inquiry in determining whether a plan provides deferred compensation requires consideration of the following factors:

> 1. Is this a welfare plan; *i.e.*, one concerned with the well-being of employees?

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recognized that it had placed emphasis in *Armantrout* on the ability of the taxpayer/employees to bargain for the form in which compensation was paid. However, in *Grant-Jacoby*, this ability was not considered an indispensable prerequisite in the determination that payments from the plan were compensation to the employees; it was more significant that the inclusion of children in the plan was a valuable reward received by the employees because of employment. *Grant-Jacoby*, 73 T.C. at 707-08. This was true even if, as was the case here, the employees had no legal obligation to provide their children with a college education. *Id.* at 709.

[95] *Id.* at 712 (quoting Latrobe Steel Co. v. Commissioner, 62 T.C. 456, 464 (1974)). The court refused to reverse its holding in *Latrobe*. Noting that the plans described in Treas. Reg. § 1.162-10 are also plans of deferred compensation, the court reiterated that not all such plans are subject to § 404(a). *Id.* at 712-13. However, the court agreed with the Service that the Grant-Jacoby plan constituted a nonqualified profit-sharing plan, and stated that, in applying *Latrobe*'s similar to test, contributions to a nonqualified plan need not be limited in exactly the same manner as qualified plans under § 401(a) to be subject to § 404. *Id.* at 715. For example, contributions to a nonqualified profit-sharing plan need not be made solely out of profits to find the plan similar to a qualified plan. *Id.*

[96] *Id.*

[97] *Id.* at 716.

[98] *See supra* note 69.

[99] 698 F.2d 1196 (Fed. Cir. 1982).

[100] *Id.* at 1198.

[101] *Id.* at 1200.

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2. Are the benefits provided employees based upon the employer's earnings?

3. Do the benefits increase for those who have been employed longer by the employer?

4. Are the benefits provided to all the employees?

5. Are the plan benefits a substitute for salary?

6. Does the plan serve its stated purpose or is it a sham?

7. Does the employer lose control of the funds it gives the plan? Is there any sort of reversion of funds to the employer? Is the plan independently administered?[102]

After considering these factors, the court concluded that Greensboro's educational plan provided a welfare benefit, not deferred compensation, and permitted Greensboro to deduct its contributions under section 162.[103]

The Tax Court, in both *Citrus*[104] and *Grant-Jacoby*,[105] reaffirmed *Latrobe*'s similar to test[106] for determining whether a benefit provides deferred compensation. Two questions remain unresolved. First, it is unclear whether the Tax Court would find deferred compensation in an educational benefit plan that covers all employees. In both *Citrus* and *Grant-Jacoby*, it was significant that the plans covered only em-

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[102] *Id.* For a more detailed analysis of these factors, see *infra* note 113 and accompanying text.

[103] *Greensboro*, 698 F.2d at 1202-03. The court distinguished the plan before it from the plan considered in Citrus Orthopedic Medical Group v. Commissioner, 72 T.C. 461 (1979). Unlike the plan in *Citrus*, Greensboro's plan was administered by an independent trustee, benefits of the plan were provided to all employees, and the benefits were not based on the company's earnings. *Id.* Although Greensboro could terminate or amend the plan, the trust fund could not revert to the benefit of the company. *Id.* at 1203 n.6. For further analysis of employer contributions to educational benefit trusts, see Lowe, *supra* note 91, at 330-32; Comment, *Educational Benefit Trusts*, *supra* note 86, at 305-13.

In Presto Prod. v. United States, 571 F. Supp. 1173 (N.D. Ga. 1983), a federal district court distinguished *Greensboro* in holding that contributions to a sick pay plan were deductible under § 404, not § 162. The *Presto* court found a key distinguishing factor in that, unlike the *Greenboro* plan, the employer in *Presto* did not set its contributions aside in a separate fund or trust and thus had use of the funds until actually paid to employees. *Presto*, 571 F. Supp. at 1173. One source suggests that *Presto* indicates the government's willingness to continue to litigate the issue of deductibility of contributions to employee benefit plans. *Sick Leave Plan Held a Deferred Compensation Plan*, 3 A.B.A. SEC. TAX'N NEWSLETTER 15, 16 (1984).

[104] *Citrus*, 72 T.C. at 468 (distinguishing *Latrobe*).

[105] *Grant-Jacoby*, 73 T.C. at 712-13.

[106] *Latrobe*, 62 T.C. at 464.

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ployee/owners.[107] This focus on plan discrimination in distinguishing deferred compensation from welfare benefits seems misplaced. Plan discrimination may be an alternative reason for denying an immediate deduction for employer contributions,[108] but the existence of discrimination sheds little light on whether compensation is deferred. Second, Congress has amended the language of section 404(b)[109] upon which *Latrobe* relied in formulating its similar to test.[110] Given the evidence that Congress may have intended by the amendment to expand application of section 404, it remains unclear whether the *Latrobe* test has any lasting viability.[111]

The Federal Circuit in *Greensboro* took an entirely different approach to defining deferred compensation. By listing several areas of consideration in evaluating the substance of the benefit provided by a plan,[112] *Greensboro* properly focused on the nature of the benefit at issue. However, the factors the court listed do not really distinguish between the two different types of plans; many characteristics are shared by both types of plans.[113] Thus, the usefulness of the *Greensboro*

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[107] *Citrus,* 72 T.C. at 468-69; *Grant-Jacoby,* 73 T.C. at 714-15.

[108] A nondiscrimination requirement is included in many of the Code provisions that exclude employee benefits from gross income. *See, e.g.*, I.R.C. § 79(d) (group term life insurance); I.R.C. § 105(h) (accident and health plans); I.R.C. § 120(c)(1) to (3) (group legal services plans); I.R.C. § 129(d)(2) to (4) (dependent care assistance); *cf.* Treas. Reg. § 1.501(c)(9)-4 (1980) (VEBA nondiscrimination requirements). Nondiscrimination is required of qualified deferred compensation plans. *See* I.R.C. §§ 401(a)(17), 416. One commentator has questioned whether the nondiscrimination requirements really further their intended purpose of inducing employers to provide coverage for lower paid workers. *See* Wolk, *supra* note 11, at 463-64.

[109] Revenue Act of 1978, Pub. L. No. 95-600, § 133(b), 92 Stat. 2763, 2783. Section 404(b) governs employers' deductions for contributions having the effect of a deferred compensation plan. Congress amended § 404(b) by striking out the phrase "similar plan" and inserting "other plan". *Id.*

[110] *Latrobe*, 62 T.C. at 464.

[111] The House Report indicated that the amendment was intended to clarify current law by providing that a method of compensation or employer contributions need not be similar to one of the enumerated plans to be subject to the deferred compensation deduction timing rules. H.R. REP. NO. 1800, 95th Cong., 2d Sess. 206 (1978). The *Grant-Jacoby* court noted this change, but held it not applicable to the case before it, and thus did not pass on its effect. Grant-Jacoby, Inc. v. Commissioner, 73 T.C. 700, 713 n.6 (1980).

[112] *Greensboro*, 698 F.2d at 1200; *see supra* text accompanying note 102.

[113] For example, one of the factors listed was whether the plan was concerned with the well-being of employees. *Greensboro*, 698 F.2d at 1200. The well-being of employees is a concern in retirement plans as well as in welfare benefit plans. Similarly, whether the benefits provided by the plan are a substitute for salary, *id.*, is an equally unrevealing inquiry. Most employers presumably consider the cost of employee benefits

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approach is questionable. The current state of case law and the conflicting approaches of the Tax Court and the Federal Circuit warrant further congressional action. The proposals recently released by the staff of the Joint Committee on Taxation[114] offer a useful starting point for initiating public discussion of this issue.

D. *Life Benefits and Retired Lives Reserves*

A retired lives reserve is a special fund established by an employer, independently or through an insurer, in which contributions and earnings accumulate until needed to cover term insurance premiums as they fall due for retired employees.[115] Because payments to a retired lives reserve are made currently on behalf of employees to provide life insurance coverage in the future, retired lives reserves arguably provide a form of deferred compensation.

The Service has ruled that employer contributions for life insurance premiums, including an allocation to a retired lives reserve, are deductible under section 162, and are not governed by section 404.[116] However, the soundness of these rulings can be questioned in light of the *Latrobe*

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in setting the level of compensation, and such benefits may be bargained for or provided as a substitute for compensation otherwise paid in cash. A plan that provides benefits to all employees, another inquiry considered relevant by the court, *id.*, may not be similar to a profit-sharing plan, but could defer the receipt of compensation nonetheless. In fact, qualified retirement plans, which surely provide deferred compensation, require nondiscrimination. *See supra* note 12.

[114] JOINT COMM. PROPOSALS, *supra* note 1, at 88-89. For further discussion of these proposals, see *infra* notes 177-81 and accompanying text.

[115] D. GREGG, LIFE AND HEALTH INSURANCE HANDBOOK 367 (3d ed. 1973); Salem & Schmalbeck, *supra* note 47, at 135.

[116] Rev. Rul. 69-382, 1969-2 C.B. 28. The ruling states that premiums are deductible by the employer under § 162 notwithstanding that a portion of the premium is credited to a retired lives reserve. Any balance in the reserve must be held by the insurer solely for living employees. The amount added to the retired lives reserve must not exceed the amount required to fairly allocate the cost of providing the coverage over the working lives of the employees. The life insurance contract cannot provide the employer with the right to recapture any part of the reserve so long as any employee is alive. *Accord* Rev. Rul. 73-599, 1973-2 C.B. 41 (contributions for life insurance premiums, including allocation to retired lives reserve, deductible under § 162 to extent such contributions are actuarially determined and made on a level basis); Rev. Rul. 69-478, 1969-2 C.B. 29 (contributions made on an actuarially determined level basis to cover group health and term life coverage deductible under § 162 even though some or all of employees benefited are retired). *But cf.* Salem & Schmalbeck, *supra* note 47, at 136 (revenue rulings permitting a deduction under § 162 are "sensible" but may not be extended to other fact situations).

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definition of deferred compensation.[117] *Latrobe* held that if a plan or method of compensation is similar to the plans listed in section 404, that section, rather than section 162, governs the deductibility of the employer's contributions. The court stated that the substance of the pension and annuity plans listed in section 404 is that they are structured to provide employees with actuarially determinable benefits upon retirement. It distinguished the vacation plan before it from pension or annuity plans because the vacation plan was not designed to provide benefits to employees upon retirement, nor were the benefits measured with reference to retirement needs.[118] Thus, the vacation plan was not similar to the plans enumerated in section 404. Retired lives reserves, however, *are* designed to provide employees with actuarially determined benefits upon retirement.[119] Therefore, even under the narrow[120] *Latrobe* test for deferred compensation, employer contributions to a retired lives reserve should be governed by section 404, not section 162.[121]

III. VEBA's and Deferred Compensation

Deferred compensation also plays a role in determining what benefits may be provided by a VEBA. As discussed in Part I, an organization that provides nonqualifying benefits cannot be described as a tax-exempt VEBA.[122] The regulations accompanying section 501(c)(9) state that nonqualifying benefits include benefits similar to the benefit provided by a pension, annuity, profit-sharing, or stock bonus plan.[123] Section 404 uses almost identical terminology to define deferred compensa-

[117] 62 T.C. 456 (1974); *see supra* notes 77-85 and accompanying text; *cf.* Consumers Power Co. v. United States, 427 F.2d 78, 80 (6th Cir. 1970) (death benefit certificates issued at retirement represent deferred compensation under § 404(a) and are not deductible until year death benefit paid), *cert. denied*, 400 U.S. 925 (1970).

[118] *Latrobe*, 62 T.C. at 464-65.

[119] In fact, the Service has only permitted deductions under § 162 to extent the contributions are actuarially determined. *See supra* note 116 and accompanying text.

[120] *See infra* notes 170-72 and accompanying text (arguing that *Latrobe* test does not adequately address deferred compensation issue).

[121] *Cf.* Treas. Reg. § 1.401-1(b)(l)(i), T.D. 7428, 1976-2 C.B. 160, 161 (plan designed to provide benefits for employees to be paid upon retirement or over a period of years after retirement considered pension plan under § 401(a) if employer's contributions can be determined actuarially on basis of definitely determinable benefits). *But cf.* Salem & Schmalbeck, *supra* note 47, at 136 (revenue rulings permitting deduction under § 162 are "eminently sensible").

[122] Treas Reg. § 1.501(c)(9)-3(a) (1980). *But see supra* note 25 regarding de minimis nonqualifying benefits.

[123] Treas. Reg. § 1.501(c)(9)-3(f) (1980).

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tion.[124] However, the VEBA regulations further define a benefit that is similar to the enumerated plans as one that "provides for deferred compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event."[125] An interesting issue arises when a benefit is specifically listed in the regulations as an example of a qualifying benefit,[126] yet appears to be payable by reason of the passage of time and thus nonqualifying.[127] This Part will analyze the application of the VEBA regulations to the four types of benefits examined in Part II.

A. *Severance Pay and Supplemental Unemployment Benefits*

The regulations state that severance and supplemental unemployment benefits that satisfy certain requirements are qualifying VEBA benefits.[128] Qualifying VEBA supplemental unemployment benefits must be paid to an employee because of involuntary separation resulting from layoffs, shutdowns, or other similar conditions.[129] Qualifying VEBA severance benefits may not be directly or indirectly contingent on the employee's retirement.[130] Severance or supplemental unemployment benefits payable for reasons other than involuntary unemployment do not meet these requirements, and do not qualify.[131] Moreover,

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[124] *Compare* Treas. Reg. § 1.501(c)(9)-3(f) (1980) *with* I.R.C. § 404(a). Section 404 governs contributions under a stock bonus, pension, profit-sharing, annuity plan, or compensation paid or accrued under a plan deferring the receipt of compensation. I.R.C. § 404(a).

[125] Treas. Reg. § 1.501(c)(9)-3(f) (1980).

[126] Treas. Reg. § 1.501(c)(9)-3(e) (1980); *see supra* note 23.

[127] Treas. Reg. § 1.501(c)(9)-3(f) (1980). For a discussion focusing on this seeming inconsistency, see *infra* notes 134-39 and accompanying text regarding vacation benefits.

[128] Qualifying benefits of this type include job readjustment allowances, supplemental unemployment compensation as defined in I.R.C. § 501(c)(17)(D)(i), and severance benefits under a severance pay plan within the meaning of 29 C.F.R. § 2510.3-2(b) (1983). Treas. Reg. § 1.501(c)(9)-3(e) (1980).

[129] I.R.C. § 501(c)(17)(D)(i); *see also* Treas. Reg. § 1.501(c)(17)-1(b)(3) (1968) (defining involuntary separation). Involuntary separation does not include separation for disciplinary reasons or because of age. Treas. Reg. § 1.501(c)(17)-1(b)(4) (1968). The VEBA regulations refer to Treas. Reg. § 1.501(c)(17)(D)(i) to define qualifying supplemental unemployment benefits. Treas. Reg. § 1.501(c)(9)-3(e) (1980).

[130] 29 C.F.R. § 2510.3-2(b) (1983). Additionally, the total payment is limited and must be completed within 24 months of termination or retirement. *Id.* Qualifying VEBA severance benefits must meet the requirements of a severance pay plan imposed by C.F.R. § 2510.3-2(b) (1983). Treas. Reg. § 1.501(c)(9)-3(e) (1980).

[131] Supplemental unemployment benefits paid absent unemployment would not meet the requirement of payment because of involuntary separation. Severance pay that is

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benefits paid absent involuntary unemployment are nonqualifying deferred compensation under the regulations because the benefits are payable as a result of the passage of time, not the unanticipated unemployment.[132] In this respect, the scope of deferred compensation that has been held to preclude deduction under section 162[133] and that results in a nonqualifying VEBA benefit is the same. A benefit that provides what is essentially retirement income, or that is paid to all employees without the contingency of involuntary unemployment, can only receive favorable tax treatment if it is included in a qualified plan.

B. Vacation Benefits

The VEBA regulations list vacation benefits as an example of qualifying benefits.[134] However, vacation is generally paid only after an employee has accumulated a requisite number of months of service.[135] For this reason, vacation benefits appear to be payable by reason of the passage of time, and thus constitute nonqualifying deferred compensation under the VEBA regulations.[136] A possible explanation for this inconsistency is that the regulations intend to limit qualifying vacation benefits to those that safeguard or improve the health of the member.[137] To qualify, vacation benefits would have to be paid not by reason of the passage of time, but to rejuvenate the member.[138] If the plan, by its terms or at the employee's discretion, accumulates vacation benefits over a period of years, the benefit no longer serves its purpose of im-

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payable at retirement would be contingent on retirement, and thus would not meet the requirements of 29 C.F.R. § 2510.3-2(b) (1983). *See* Glickman, *supra* note 16, at 746 (payment of benefits upon termination for any reason impermissible VEBA benefit).

[132] *See* Treas. Reg. § 1.501(c)(9)-3(f) (1980).

[133] *See* New York Seven-up Bottling Co. v. Commissioner, 50 T.C. 391 (1968); New York Post Corp. v. Commissioner, 40 T.C. 882 (1963); *cf.* Lundy Packing Co. v. United States, 302 F. Supp. 182 (E.D.N.C. 1969) (sick pay), *aff'd per curiam*, 421 F.2d 850 (4th Cir. 1970).

[134] Treas. Reg. § 1.501(c)(9)-3(e) (1980).

[135] For example, *Latrobe*'s plan required an employee to have worked at least one year to be eligible for any vacation. Latrobe Steel Co. v. Commissioner, 62 T.C. 456, 457 (1974).

[136] Treas. Reg. § 1.501(c)(9)-3(f) (1980). If the benefit is accumulated, it more closely resembles a nonqualifying savings facility or deferred compensation benefit than it does a benefit paid for vacation.

[137] Treas. Reg. § 1.501(c)(99)-3(d)(1) (1980); *cf.* G.C.M. 39116 (Jan. 12, 1984) (vacation benefits presumably qualify for VEBA in that, by providing the rest and relaxation necessary for mental and physical well-being, they are intended to safeguard or improve the member's health).

[138] *Cf.* G.C.M. 39116 (Jan. 12, 1984).

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proving the member's health and arguably does not qualify.[139]

C. Educational Benefit Plans

The VEBA regulations list educational benefits for an employee/member as qualifying VEBA benefits because such benefits protect against a contingency that impairs or impedes earnings power,[140] presumably by protecting against obsolescence of the employee's skills and knowledge. Although the regulations do not specifically list educational benefits for dependents, qualifying benefits include any benefit provided by the Labor Management Relations Act of 1947 (LMRA).[141] Scholarships provided by collectively bargained plans for the benefit of employees, their families, and dependents are among the benefits listed by the LMRA.[142] However, the examples of qualifying benefits in the VEBA regulations, including educational benefits, must be read with reference to the overall principle governing qualifying other benefits.[143] Educational benefits for dependents do not appear to meet either of the two requirements of qualifying VEBA benefits: they neither safeguard or improve the health of the member or dependent,[144] nor protect against a contingency that impairs or impedes the member's earning power.[145] Therefore, because educational benefits for dependents are not similar to life, sick, or accident benefits within the meaning of the VEBA regulations, they should not qualify. Educational benefits for dependents

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[139] This conclusion may find some support by analogy in § 463, governing deduction of accrued vacation benefits. Under that section, only that accrued vacation pay earned in one year and payable within 12 months following the end of the taxable year earned is deductible. I.R.C. § 463(a); *cf.* G.C.M. 39116 (Jan. 12, 1984) (right to designate third party payee for VEBA vacation benefits nonqualifying benefit because once vacation pay is assigned, it may no longer be used by the member for vacation).

The conclusion that extended vacation benefits are not qualifying VEBA benefits should be contrasted with the approach taken under the provisions governing the employer's deduction. An extended vacation plan has been held not similar to the deferred compensation plans listed in § 404(a) and thus contributions to the plan were deductible under § 162. Latrobe Steel. Co. v. Commissioner, 62 T.C. 456, 464-65 (1974). Even assuming *Latrobe* is still valid, *see supra* notes 109-11, the difference in result can be explained. The VEBA regulations not only focus on nonqualifying deferral, but also examine the nature of the benefit to determine if it qualifies.

[140] Treas. Reg. § 1.501(c)(9)-3(e) (1980).

[141] *Id.*

[142] Labor Management Relations Act of 1947, ch. 120, § 302(c)(5), 61 Stat. 136, 157 (codified as amended at 29 U.S.C. § 186(c) (1976)).

[143] Treas. Reg. § 1.501(c)(9)-3(d) (1980); *see supra* note 23.

[144] Treas. Reg. § 1.501(c)(9)-3(d)(1) (1980).

[145] Treas. Reg. § 1.501(c)(9)-3(d)(2) (1980).

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may also come within the definition of nonqualifying VEBA benefits. Although they are not paid merely because of the passage of time,[146] neither are they paid as a result of an unanticipated event.[147] While the Service has expressed some approval of dependent's educational benefits,[148] it remains unclear that such benefits should qualify.

D. *Retired Lives Reserves*

The Code expressly includes life benefits as qualifying VEBA benefits.[149] The regulations define a life benefit as one payable by reason of the death of a member or dependent.[150] Payment of current life benefits to retired members, permitted under the VEBA regulations,[151] is not deferred compensation, but should be distinguished from accumulating life insurance premiums during the employee's working life to be paid after retirement. Because qualifying life benefits must consist of current protection,[152] a retired lives reserve, which funds future insurance pro-

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[146] Treas. Reg. § 1.501(c)(9)-3(f) (1980). Commonly the child of the employee must be a student at an educational institution to receive benefits, and the parent must still be employed by the contributing employer.

[147] Treas. Reg. § 1.501(c)(9)-3(f) (1980). Attending college does not appear to be an unanticipated event in the same way as is, for instance, becoming unemployed or incurring medical expenses. From a policy perspective, it would seem inequitable to permit some employees to receive tax favored educational benefits for dependents, given the current controversy over tuition tax-credits for the general population. *See generally* Comment, *Social Implications and Constitutionality of Recent Proposals for Tuition Tax Credits for Parents of Private School Children*, 51 UMKC L. REV. 286 (1983).

[148] The Service has ruled that scholarship benefits provided to children of VEBA members as a result of collective bargaining are qualifying benefits. LTR 8101003 (Sept. 26, 1980); *see also* Lowe, *supra* note 91, at 333 (educational benefits for dependents qualifying VEBA benefits and not limited to collectively bargained plans, although the Service may take contrary position). The preamble to the VEBA regulations indicates that scholarship benefits are permitted only if the benefit is not similar to a pension plan. T.D. 7750 (Preamble), 1981-1 C.B. 338, 340.

[149] I.R.C. § 501(c)(9). This express provision in the Code should be contrasted with listing a benefit as qualifying in the regulations. *Compare* I.R.C. § 501(c)(a) *with* Treas. Reg. § 1.501(c)(9)-3(e) (1980) (examples of qualifying benefits). A benefit expressly provided in the Code should be given greater deference as it more clearly evidences congressional intent than do the regulations.

[150] Treas. Reg. § 1.501(c)(9)-3(b) (1980).

[151] The membership of a VEBA must consist of individuals who became entitled to participate by reason of their status as employees. Treas. Reg. § 1.501(c)(9)-2(a)(1) (1980). However, an employee who became entitled to membership may continue as a member after retirement. Treas. Reg. § 1.501(c)(9)-2(b)(2) (1980).

[152] Treas. Reg. § 1.501(c)(9)-3(b) (1980). A life benefit may include the right to convert to individual coverage on termination of eligibility through the association. *Id.* A retired lives reserve, however, is distinguishable from the right to convert to individ-

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tection, is arguably not a life benefit within the meaning of section 501(c)(9).

The VEBA regulations set forth exceptions to the current protection requirement.[153] One such exception permits a permanent benefit as defined in and subject to the conditions in the regulations under section 79 of the Code, which cover group term life insurance.[154] The section 79 regulations define a permanent benefit as an economic benefit provided by a policy which extends beyond one policy year.[155] If a retired lives reserve is a permanent benefit,[156] it will qualify as a VEBA benefit only if it meets the conditions set forth in the section 79 regulations.[157]

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ual coverage because it is the continuation of the group term coverage. A related issue is whether VEBA's can be funded with cash value policies. This is discussed in Powell & Schumaker, *supra* note 14, at 74-77.

[153] Treas. Reg.] 1.5]01(c)(9)-3(b) (1980).

[154] Treas. Reg. § 1.501(c)(9)-3(b) (1980); *see also* I.R.C. § 79. The general rule of § 79 requires the cost of group term life insurance paid by an employer to be included in the employee's income to the extent the cost exceeds the sum of the cost of $50,000 of insurance and any amount paid by the employee toward its purchase. I.R.C. § 79. An exception to the $50,000 limit on tax-free group term life insurance is provided for retired employees. I.R.C. § 79(b)(1).

[155] Treas. Reg. § 1.79-0 (1979). The regulations give examples of what are and are not permanent benefits. Permanent benefits include paid-up life insurance and cash surrender policies. Although a retired lives reserve does not resemble these examples, a reserve does provide economic value extending beyond one policy year, and arguably is a permanent benefit. The regulations provide examples of three features that are not permanent benefits. The first is a right to convert or continue life insurance after group term life insurance terminates. A retired lives reserves does not involve a mere right to convert life insurance, nor is it a continuation after termination of group term life insurance, but represents a continuation of the group life insurance itself. The second exception to the definition of permanent benefits is a benefit that does not provide any economic benefits other than current insurance protection to the employee. *Id.* A retired lives reserve may come within this exception. While future life insurance coverage would seem to provide an economic benefit beyond current insurance protection, this economic value may not be provided to the employee as is required by the regulations, because the employee may not have a vested right to the future coverage. The last example relates to a five-year level term policy which has no relevance with respect to retired lives reserves. For further analysis of § 79, see Salem and Schmalbeck, *supra* note 47, at 130-31, 135-36 (discussing permanent benefits and retired lives reserves).

[156] The Internal Revenue Service has not taken a position on whether retired lives reserves are permanent benefits within the meaning of § 79, and has imposed an informal freeze on rulings in this area. Salem & Schmalbeck, *supra* note 47, at 135. Commmentators have suggested that retired lives do not constitute permanent benefits. *Id.* at 136.

[157] Treas. Reg. § 1.501(c)(9)-3(b) (1980). Group term life insurance for purposes of § 79 must meet four conditions. It must: i) provide a death benefit excludable from

Alternatively, if retired lives reserves are not qualifying life benefits,[158] or do not satisfy the section 79 conditions,[159] retired lives reserves may still qualify as other benefits under the VEBA regulations.[160] However, an examination of the regulations defining qualifying other benefits suggests that retired lives reserves do not qualify. Retired lives reserves neither safeguard or improve the member's health,[161] nor protect against a contingency that impairs a member's earning power.[162] Moreover, retired lives reserves resemble nonqualifying deferred compensation similar to a pension or annuity.[163] Although the ultimate payment of the life benefit is payable at death, which is an unanticipated event,[164] the employer's contribution for life insurance protection

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gross income under § 101(a) of the Code; ii) be provided to a group of employees; iii) be provided under a policy carried by the employer; and iv) the amount of insurance provided to each employee must be computed under a formula that precludes individual selection. Treas. Reg. § 1.79-1(a), T.D. 7623, 1979-1 C.B. 66, 70-73.

Group term life insurance that is combined with permanent benefits under § 79 must also meet four conditions: i) the policy or employer must designate in writing the part of the death benefit that is group term life insurance; ii) the death benefit designated as group term life must be limited as required in the regulations; iii) the employee must be allowed to elect to decline or drop the permanent benefit; and iv) the designated group term life benefit cannot be reduced because of the employee's election to drop or decline the permanent benefit. Treas. Reg. § 1.79-1(b), T.D. 7623, 1979-1 C.B. 66, 70-73; *see also* Treas. Reg. § 1.79-1(d) (providing complex formulas for allocating group term life and permanent portions of coverage; any permanent benefit thus determined included in employee's income).

[158] The Service has not taken a position on whether retired lives reserves are life benefits within the meaning of I.R.C. § 501(c)(9). Note, however, that the term life benefit does not include a pension, annuity, or similar benefit. Treas. Reg. § 1.501(c)(9)-3(b) (1980). For an argument that retired lives reserves are similar to such benefits, see *supra* notes 116-21 and accompanying text.

[159] *See supra* note 157.

[160] Treas. Reg. § 1.501(c)(9)-3(d) (1980).

[161] Treas. Reg. § 1.501(c)(9)-3(d)(1) (1980). Retired lives reserves do not safeguard or improve the member's health, as the benefit relates to the member's death.

[162] Treas. Reg. § 1.501(c)(9)-3(d)(2) (1980). Retired lives reserves do not protect against a contingency that interrupts or impairs a member's earning power, because, although the death of a working member may constitute such a contingency, a death benefit after retirement no longer relates to the member's earning power with the employer. Retired lives reserves may protect the retirement income of a retired member. Therefore, a retired lives reserve or similar arrangement should be provided through a qualified plan so as not to frustrate congressional intent. *Cf. infra* notes 166-69 and accompanying text (retirement and related plans). Qualified pension plans may provide incidental death benefits. Treas. Reg. § 1.401-1(b)(1)(i), T.D. 7428, 1976-2 C.B. 160, 161.

[163] Treas. Reg. § 1.501(c)(9)-3(f) (1980); *see also supra* notes 116-21.

[164] *See* Treas. Reg. § 1.501(c)(9)-3(f) (1980).

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is effectively made on behalf of the member at retirement. Therefore, as discussed with reference to the employer's deduction,[165] retired lives reserve should be considered deferred compensation.

IV. Toward a Workable Solution

The cases defining deferred compensation fall far short of establishing a bright-line distinction between a plan that provides deferred compensation and a plan that does not. A workable approach to defining deferred compensation has yet to be achieved. Whatever approach is employed should focus on the policy underlying the distinction between deferred compensation and welfare benefits.

Congress has determined that certain employee benefits should be encouraged, and has used the tax system to provide incentives to employers to establish plans providing such benefits.[166] In evaluating whether contributions to a plan should be immediately deductible, or whether a VEBA should be exempt from taxation, the courts should focus on the nature of the benefit provided by the plan, and whether it is the type of benefit that Congress has sought to encourage. One such encouraged benefit is retirement for employees.[167] However, Congress intended that only those retirement and related plans that satisfy specific requirements should qualify for favorable tax treatment.[168] The *Latrobe* approach, which precludes immediate deduction of employer contributions to plans that resemble qualified plans,[169] appropriately prevents evasion of the qualification requirements.

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[165] *See supra* notes 116-21 and accompanying text.

[166] Thus, an employer's contributions to plans that provide welfare benefits are deductible in the taxable year paid or accrued, *see* Treas. Reg. § 1.162-10 (1960); *supra* notes 38-43, the plan may be tax-exempt, *see* I.R.C. § 501(c)(9); *supra* notes 19-36, and the benefit may be excluded from the employee's taxable income, *see supra* note 47.

Commentators have disagreed on whether the tax system is the proper vehicle to achieve non-tax goals. *See generally* S. SURREY, PATHWAYS TO TAX REFORM (1973); Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969); Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970); Surrey & Helmuth, *The Tax Expenditure Budget — Response to Professor Bittker*, 22 NAT'L TAX J. 528 (1968).

[167] *See* H.R. REP. NO. 2333, 77th Cong., 2d Sess. 103 (1942); *see also supra* note 12 (discussing tax advantages associated with qualified retirement plans).

[168] *See* H.R. REP. NO. 533, 93d Cong., 1st Sess. 1-3 (1973); *see also supra* note 12 (discussing requirements for plan qualification).

[169] Latrobe Steel Co. v. Commissioner, 62 T.C. 456, 464-65 (1974); *see supra* notes 77-85 and accompanying text.

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However, the concern with preventing abuse associated with deferred compensation arrangements should extend beyond denying tax advantages to plans that are similar to the qualified plans but which fail to meet the qualification requirements. In applying its similar to test, *Latrobe* allowed immediate deduction of extended vacation benefits.[170] Although it may be desirable to offer favorable tax treatment to encourage employers to provide annual vacations to employees,[171] the justification for the government's effective grant of an interest free loan[172] to fund extended vacations seems lacking. Ideally, Congress should clearly specify and define the benefits to which it will extend favorable tax treatment, instead of generally sanctioning welfare benefits. While the rigidity of this approach may discourage innovation of new benefits, Congress could add to the list of favored benefits.[173] Under this approach, any benefit not expressly listed as a welfare benefit would be treated as deferred compensation.

The VEBA regulations offer an alternative approach to distinguish between deferred compensation and welfare benefits, which could be modified to apply in the context of the employer's deduction. Under this approach, welfare benefits would be required to either safeguard or improve the health of an employee or her dependents,[174] or protect against a contingency that impairs an employee's earning power,[175] to receive favorable tax treatment. This approach would require courts to thoroughly evaluate the nature of the benefit. While this standard may not result in favorable tax treatment for all desired benefits, Congress could add specific benefits that do not fit within the general principle, but nonetheless are seen as worthy of favorable treatment.[176]

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[170] *Id.* at 465.

[171] *Cf.* Treas. Reg. § 1.162-10(a) (1960) (deduction for contributions to vacation pay plan allowable in taxable year paid or accrued); Treas. Reg. § 1.501(c)(9)-3(e) (1981) (vacation benefits qualifying in VEBA). *But see supra* notes 137-39 and accompanying text (arguing that qualifying VEBA vacation benefits should be limited to annual vacation pay).

[172] An immediate deduction for contribution to a plan, when coupled with deferral of employee recognition of income and tax exemption of the plan, has the same effect as an interest-free loan of the amount deducted. *See supra* note 11.

[173] Congress has taken similar action in the past by excluding certain employment related benefits from gross income. *See, e.g.*, I.R.C. § 120 (group legal services plan); I.R.C. § 124 (employer-provided transportation); I.R.C. § 129 (dependent care assistance).

[174] *See* Treas. Reg. § 1.501(c)(9)-3(d)(1) (1981).

[175] *See* Treas. Reg. § 1.501(c)(9)-3(d)(2) (1981).

[176] For example, dependent care assistance and van-pooling would not satisfy the proposed standard, as such benefits do not necessarily safeguard or improve the health

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The proposals released by the staff of the Joint Committee on Taxation[177] address the issue of defining deferred compensation from a different angle. Instead of focusing on the nature of the benefit, the proposals examine the degree of deferral. As a bright-line rule, deferred compensation plans are defined to include any plan that provides a benefit that cannot, by its terms as applied to participating employees, be paid during the current taxable year or the following year.[178] The Committee further suggests that the amount of an employer's deduction for contributions to funded welfare plans be limited,[179] and that timing of the employer's deduction be keyed to inclusion of the benefit in the employee's income.[180] These suggestions, if implemented, would reduce the favorable tax treatment currently enjoyed by welfare plans,[181] but would offer a sorely needed uniform and objective approach in the employee benefits area.

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of an employee or her dependents, or protect against an impairment of earning power. Nor would these benefits be paid as a result of an unanticipated contingency. Yet, congressional approval of these benefits is evident. *See* I.R.C. § 124 (employer-provided transportion); I.R.C. § 129 (dependent care assistance).

[177] *See* JOINT COMM. PROPOSALS, *supra* note 1, at 86-89.

[178] *Id.* at 89. This treatment would apply both to the timing of the employer's deduction and to defining qualifying VEBA benefits. Any benefit payable because of an unanticipated contingency would not fall within this definition, as those benefits could (although not necessarily would) be payable within the current or following taxable year.

[179] *Id.* at 86-87. Specifically, the proposals limit a deduction for a contribution to funded welfare benefit plans to the sum of (1) the amount of contribution includable in the employees' gross income (disregarding the effect of statutory exclusions), (2) previous deductions not allowed which are now includable in the employees' gross income, and (3) additions to a plan reserve. The amount of the reserve is also limited. *Id.* at 87.

[180] *Id.* at 87. The employer can deduct its contribution in the year the benefit is includable in the employee's gross income. This time will be the earlier of the time at which the employee's interest is substantially vested, actually received, or constructively received. *Id.*; *see supra* note 47 (discussing recognition of income). This approach to funded welfare plans generally conforms to that taken with respect to nonqualified deferred compensation plans. JOINT COMM. PROPOSALS, *supra* note 1, at 86.

The proposals also clarify VEBA nondiscrimination rules. VEBA benefits provided to officers, owners, or highly compensated employees are limited to 25% of total annual benefits provided. Any benefit violating nondiscrimination standards, or contingent only upon performance of additional services (such as vacation pay), would be considered wages and included in income notwithstanding a statutory exclusion of the benefit. The proposals also set maximums on the amount of VEBA provided severance pay and supplemental unemployment benefits. JOINT COMM. PROPOSALS, *supra* note 1, at 88.

[181] For instance, under current law an employer may deduct its contribution to a welfare plan without regard to when the benefit is included in the employee's gross income. Treas. Reg. § 1.162-10(a) (1960).

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The proposed Tax Reform Act of 1984 and the proposed Deficit Reduction Tax Act of 1984 detail and expand the Joint Committee proposals.[182] The report accompanying the House bill indicates intent to contract the favorable treatment that contributions to welfare plans currently enjoy.[183] Under the House bill, contributions to welfare plans, including VEBA's,[184] are no longer deductible under section 162, but are instead deductible under new section 419.[185] Only plans providing life insurance, accident, sickness, severance pay, supplemental unemployment, or group legal benefits may accumulate funds,[186] and the amount of accumulation is limited.[187] Both the Senate and House bills amend section 404(b) to clarify treatment of unfunded deferred compensation plans.[188] The ambiguities in distinguishing welfare benefits

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[182] Deficit Reduction Tax Act of 1984, *supra* note 3, §§ 95-97, at 297-313; Tax Reform Act of 1984, *supra* note 2, §§ 111-113, at 200-16.

[183] *See* H.R. REP. No. 432, 98th Cong., 2d Sess. 1275 (1984) (favorable treatment of employer contributions to welfare benefit plans inappropriate; current rules allow excessive tax-free accumulation of funds). The House Report notes with disfavor abuses connected with VEBA's and Greensboro Pathology Assocs. v. United States, 698 F.2d 1196 (Fed. Cir. 1982). *See* H.R. REP. No. 432, 98th Cong., 2d Sess. 1274-76 (1984).

[184] Tax Reform Act of 1984, *supra* note 2, § 111, at 207.

[185] *See id.* § 111, at 201-06. The plan's "qualified cost" is deductible in the taxable year paid. Qualified cost represents the sum of the amount the employer could deduct under the cash method of accounting had benefits been directly paid to employees, plus an addition to a "qualified asset account." The qualified asset account is a reserve for pre-funding welfare benefits, and is limited to an amount sufficient to maintain 75% of the average annual qualified direct cost for the current and preceding taxable year. The qualified cost is reduced by the plan's after-tax income. *Id.* at 201-04; *see also* H.R. REP. No. 432, 98th Cong., 2d Sess. 1277-80 (1984).

[186] Tax Reform Act of 1984, *supra* note 2, § 111, at 205. Thus, educational benefit plans seem precluded. Vacation plans are governed by I.R.C. § 463, also amended by the Act. Tax Reform Act of 1984, *supra* note 2, § 117, at 221 (vacation pay deductible only to extent expected to be paid within taxable year earned or following taxable year). Retired lives reserves appear subject to the rules governing unfunded deferred compensation. *See* H.R. REP. No. 432, 98th Cong., 2d Sess. 1283 (1984).

[187] *See supra* note 185 (defining qualified asset account).

[188] Deficit Reduction Tax Act of 1984, *supra* note 3, § 96, at 307-08; Tax Reform Act of 1984, *supra* note 2, § 112, at 210-12; *see also* S. REP. No. 169, 98th Cong., 2d Sess. 324-25 (1984); H.R. REP. No. 432, 98th Cong., 2d Sess. 1282-84 (1984). It is unclear whether the House provisions are intended to apply only to unfunded deferred benefits, or also apply to funded deferred compensation plans that are not qualified under § 404.

Both bills clarify and tighten nondiscrimination rules applicable to VEBA's. Deficit Reduction Tax Act of 1984, *supra* note 3, § 95, at 297-302; Tax Reform Act of 1984, *supra* note 2, § 113, at 212-16; *see also* S. REP. No. 169, 98th Cong., 2d Sess. 319-22 (1984); H.R. REP. No. 432, 98th Cong., 2d Sess. 1285-91 (1984).

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from deferred compensation, however, are not resolved by either bill.[189] The House bill instead reduces the incentive for abuse by restricting the timing and amount of deductible contributions to welfare plans;[190] the Senate bill imposes an excise tax on discriminatory funded welfare plans.[191] A specific definition of deferred compensation, such as that given in the Joint Committee's proposals,[192] would greatly clarify application of the proposed statute.

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[189] The House Report claims that its bill clarifies this distinction. H.R. REP. NO. 432, 98th Cong., 2d Sess. 1282 (1984). However, clarity seems lost in the morass of statutory language. A welfare benefit is defined by § 419 as any benefit except those to which the following sections apply: I.R.C. § 83(h) (deduction for transfers of property in connection with the performance of services), § 404 (deduction for deferred compensation plans), § 404A (deduction for foreign deferred compensation plans), or election under § 463 (vacation plans). Tax Reform Act of 1984, *supra* note 2, § 111, at 207. The Senate provisions defining welfare plans are similar. *See* Deficit Reduction Tax Act of 1984, *supra* note 3, § 96, at 307-08. Thus, welfare benefits are defined, as they were in Treas. Reg. § 1.162(a)-10 (1960), with reference to other sections of the Code. To confuse matters further, the exception for § 404 applies as determined without reference to the new subsection § 404(b)(2).

Turning to § 404, only § 404(b) is amended. Tax Reform Act of 1984, *supra* note 2, § 112, at 210-12. Section 404(b)(2)(A) states that "any plan providing for deferred benefits (other than compensation) for employees, their spouses, or their dependents shall be treated as a plan deferring the receipt of compensation." *Id.* at 211. However, § 404(b)(2)(B) states that this definition does not apply to § 419(e) welfare benefit funds. *Id.* Thus, the new rules distinguishing welfare benefit plans from deferred compensation plans seem to be inoperable by the very terms of the statute. It is unclear under the statute whether the current definitions, the ambiguity of which are the subject of this Comment, still apply.

The House Report is also far from clear on this issue. It provides that a plan is a welfare benefit plan if it provides welfare benefits, but is not if it provides deferred compensation. H.R. REP. NO. 432, 98th Cong., 2d Sess. 1280 (1984). The House Report later states that the "test" for whether a benefit is deferred is "applied by determining whether a benefit would, if considered to be compensation, be considered to be deferred compensation," but then repeats that a funded welfare plan "would not be considered a plan of deferred compensation." *Id.* at 1283. The definition of deferred compensation is by no means clear, although it does seem that *Latrobe*'s similar to test does not apply, at least with respect to unfunded deferred compensation plans. *Id.* (arrangement for compensation having effect of deferred compensation plan need not be similar to § 404 enumerated plans to be governed by that section).

[190] *See* Tax Reform Act of 1984, *supra* note 2, § 111, at 200-07; *see also supra* notes 183-87.

[191] Deficit Reduction Tax Act of 1984, *supra* note 3, § 96, at 302-11.

[192] *See supra* note 178 and accompanying text.

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Conclusion

The current Code and regulations offer courts little guidance in determining what types of benefits are deferred compensation subject to the employer's deduction timing rules. Courts have focused on the degree to which a benefit is similar to the qualified plans specifically listed in the Code sections governing deferred compensation plans. While this approach serves a useful function in preventing evasion of requirements applicable to qualified plans, it fails to address more general problems associated with deferral.

The provisions permitting immediate deduction of an employer's contributions to a plan and the provisions relating to tax-exemption of the plan reflect congressional approval of the types of benefits provided by such plans. Therefore, the proper inquiry in determining whether a benefit will receive favorable tax treatment should focus on the nature of the benefit at issue. This inquiry is more clearly reflected in the VEBA regulations than in the Code provisions governing deductions. If the benefit is not of the type that Congress has sought to encourage through tax incentives, it should not receive favorable tax treatment regardless of the benefit's dissimilarity to qualified deferred compensation plans.

Congress should take note of the restrictive manner in which the courts have interpreted the Code provisions applicable to the employer's deduction, and clarify its position. An alternative to an inquiry into the nature of the benefit at issue would be adoption, in whole or in part, of the proposals set forth by the Staff of the Joint Committee on Taxation, which examine the degree of deferral. While not offering maximum tax advantage to some benefits, the proposals have the benefit of a bright-line, uniform approach to a thorny issue.

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